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Proposed Bankruptcy Act Amendments

Report of the Advisory Committee on Bankruptcy and Insolvency

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The Honourable Michel Côté
Minister
Consumer and Corporate Affairs
Government of Canada

Mr. Minister:

I, the undersigned, Chairman of the Advisory Committee on Bankruptcy and Insolvency, have the honour to submit the Committee's report.

Gary F. Colter
Chairman

Attach.

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CONTENTS

		Page
I	SUMMARY OF MAJOR RECOMMENDATIONS	1
II	INTRODUCTION	18
III	OBJECTIVES OF BANKRUPTCY LEGISLATION	20
IV	SUBJECT MATTERS REQUIRING REFORM	21
	Wage Earner Protection	21
	Receivers and Secured Creditors	35
	Commercial Reorganizations	49
	Suppliers of Merchandise	64
	Consumer Bankruptcies and Arrangements	67
	Preferred Claims	76
	Farmers and Fishermen	82
	Securities Firms, Insurance Companies and Financial Institutions	89
	International Insolvencies	99
	Estate Administrative Matters	102
	Directors' and Officers' Liability	111
	Technical Amendments	116
V	CONCLUSION	131

SUMMARY OF MAJOR RECOMMENDATIONS

Wage Earner Protection

1. A fund should be established for the purpose of paying the arrears of wages of employees whose employers have been either declared bankrupt or put into receivership. Such a fund is the best method of ensuring that employees of insolvent companies are promptly paid their arrears of wages.

2. The wage earner protection fund should be financed by contributions from employers and employees.

3. Employees related to the insolvent employer should not be entitled to any payments out of the fund.

4. Employees should be entitled to be paid the following:

   - o arrears of gross wages and commission earned within the six months preceding the insolvency;
   - o arrears of vacation pay earned within the 12 months preceding the insolvency;
   - o arrears of all amounts withheld from the employee such on pension benefits, and union dues;

provided that the maximum payment should not exceed $2,000 per employee; and

   - o arrears of expenses incurred by the employee on behalf of the employer to a maximum of $1,000 per employee in the two months preceding the insolvency.

5. The fund should be administered by the Unemployment Insurance section of the Department of Employment and Immigration.

6. Payments to employees should be made by the trustee or receiver.

7. The fees and expenses of the trustee or receiver resulting from processing the special preferred claims of the wage earners should also be paid by the fund.

8. Any amounts paid by the fund should be subrogated as special preferred status claims under Section 107 of the *Bankruptcy Act* ranking immediately after the costs of administration.

9. Any amounts due to employees for severance pay should remain as unsecured claims ranking with other unsecured claims against the employer.

Receivers and Secured Creditors

10. The *Bankruptcy Act* should be amended for the purpose of controlling the appointment and conduct of a receiver where there is an insolvent debtor, whether or not the debtor is formally adjudged bankrupt.

11. A secured creditor who is entitled to take possession or control under a security agreement or to appoint a receiver of all or substantially all the property or inventory of an insolvent debtor should be required to obtain leave of the bankruptcy court before so doing, unless the creditor applies for the appointment of a receiver under provincial legislation.

12. To obtain such leave the secured creditor should be required to prove the following:

- the debtor was in default under the terms of the security agreement;
- under the terms of the security agreement the secured creditor was entitled to have a receiver appointed; and
- the debtor was insolvent.

If the first two above facts are proven, the debtor should be presumed to be insolvent. However, the debtor should be entitled to produce evidence to rebut the presumption.

13. The secured creditor should be required to serve a petition for leave to appoint a receiver at least eight days before the return of the petition, provided that if urgency is shown the court should have the power to abridge the eight days' notice.

14. If the petition for leave is not opposed, it should be heard by the registrar. If the petition is opposed, the registrar should be required to adjourn the matter to be heard by a judge no later than seven days after the original date for the return of the petition unless the parties consent to a later date.

15. The Chief Justice of each province should be required to designate one or more judges to be available at least weekly to hear the bankruptcy and insolvency matters.

16. Only a licensed trustee should be entitled to act as a receiver.

17. There should be no change with respect to the appointment of a receiver by the court under provincial legislation.

18. The right of a secured creditor or receiver to sell any property of the debtor out of the ordinary course of business or to remove it from the debtor's premises should be stayed for a period of 21 days after the receiver has been appointed unless leave of the court is obtained.

19. During the 21-day period the receiver should be entitled to exercise the following powers:

- to take possession of the property of the debtor but not to remove it from the debtor's premises;
- to collect accounts receivable;
- to sell property that is perishable or likely to depreciate rapidly in value;
- to carry on the business of the debtor; and
- to solicit but not accept offers to purchase the assets.

20. If the secured creditor is able to establish that he is not adequately secured, the court should have the power to shorten the automatic stay period.

21. A secured creditor should be considered adequately secured if any one of the following is established:

- the forced sale realizable value of the assets significantly exceeds the debt owing to the secured creditor;
- the secured creditor has and will be receiving payments on account and there will be no significant deterioration in the value of the assets subject to the security; or
- assets such as inventory or accounts receivable have and will be acquired to replace assets being utilized for carrying on the business, and there will be no significant deterioration in the value of the assets subject to the security.

22. If a trustee in bankruptcy is appointed within the 21-day automatic stay period, the trustee should have the right to a further 21-day stay of proceedings upon satisfying the court that:

- o additional time is required to investigate the affairs of the bankrupt; and
- o there appears to be a reasonable prospect of rehabilitating the business of the debtor or selling it as a going concern for an amount in excess of the amount owing to the secured creditor.

23. A trustee seeking a further extension of the stay period or any enlargement of the scope of the stay should bear the onus of satisfying the court that the secured creditor is adequately secured.

24. Upon the appointment of a trustee in bankruptcy or the appointment of a receiver, any interested party should have the right to apply to the court to have a stay of proceedings imposed on any secured creditor or to enlarge the terms of the stay imposed on the receiver or secured creditor. Such a stay should only be imposed if the court is satisfied that the secured creditor is adequately secured.

25. Any receiver appointed by or with leave of the court should be required to give notice of its appointment to all creditors within five days after its appointment, as well as other information relating to the affairs of the debtor.

26. A receiver should be required to deliver semi-annually to the trustee of a bankrupt estate, or to file with the Official Receiver if no trustee is appointed, a report on the administration of the receivership.

27. A receiver should be required to provide a copy of its final accounts to the trustee of the bankrupt estate or to the Official Receiver if no trustee has been appointed.

28. A secured creditor or receiver should be required to report to the trustee of the bankrupt estate the results of realization after a sale is completed.

29. The trustee of the bankrupt estate should be given the right to require a secured creditor or receiver to have its accounts approved by the court.

30. If there is no bankruptcy, the debtor and any other party, including any creditor, should be given the right to apply to the court for an order requiring a secured creditor or receiver to pass its accounts.

31. A definition of a conflict of interest should be inserted in the *Bankruptcy Act*.

32. A person should be specifically prohibited from acting as a trustee, interim receiver or receiver when a conflict of interest arises. Such a conflict of interest should be deemed to exist when the person is or at any time during the two preceding years was:

- a director or officer of the debtor,
- an employer or employee of the debtor or of a director or an officer of the debtor,
- related to the debtor or to any director or officer of the debtor,
- the auditor or accountant of the debtor, or
- related to, or the partner of, the auditor or accountant of the debtor.

33. No person should be appointed to act as a receiver for a secured creditor if that person is the trustee of the bankrupt estate or is acting as trustee under a proposal by the debtor.

34. No person should be appointed to act as trustee of a bankrupt estate or trustee under a proposal, if such person has already been appointed to act as a receiver for a secured creditor claiming a security interest in the property of the bankrupt.

Commercial Reorganizations

35. An insolvent debtor should have the right to file a Notice of Stay with the Official Receiver. This would have the effect of staying proceedings by unsecured creditors and, if a receiver has not already been appointed, staying the rights of secured creditors or a receiver to sell any property of the debtor out of the ordinary course of business or to remove it from the debtor's premises for 21 days.

36. During the 21-day period the secured creditor or receiver should be entitled to exercise the following powers:

- to take possession of the property of the debtor but not to remove it from the debtor's premises;
- to collect accounts receivable;

- o to sell property that is perishable or likely to depreciate rapidly in value;
- o to carry on the business of the debtor; and
- o to solicit but not accept offers to purchase the assets.

37. The same stay of proceedings would be applicable when a trustee of a bankrupt estate is appointed, whether or not a proposal has been filed.

38. On the filing of a Notice of Stay, if no receiver has been appointed, the debtor should be required to appoint a licensed trustee to act as interim receiver with the powers stipulated in the appointment. Such powers unless the court otherwise orders, should include the right to review the books and records of the debtor and to account for the disposition of the property of the debtor during the interim receivership. Additional powers that might be given to the interim receiver in the appointment or by the court should include:

- o making an inventory of the property of the debtor;
- o taking possession of all or part of the property of the debtor;
- o selling all or part of the assets of the debtor;
- o managing the business of the debtor; and
- o borrowing money and giving security on the assets of the debtor with the approval of the court.

39. If any creditor is dissatisfied with the party appointed as interim receiver or the powers granted to the interim receiver, the creditor should have the right to apply to the court for an order substituting another licensed trustee as interim receiver or varying the powers of the interim receiver.

40. During the stay period any secured creditor who had the right to appoint a receiver should be entitled to elect either to appoint a receiver without obtaining leave of the court or to appoint a monitor instead. Such monitor should be entitled to inspect and obtain all relevant information relating to the secured assets and the use to which they are being put during the stay.

41. If a proposal is filed, the stay should be extended for a further period of 21 days to give the creditors the right

to vote on the proposal. The meeting of creditors should be required to be held within 21 days after the filing of the proposal.

42. After the filing of a Notice of Stay or a proposal the court should have the same powers to shorten or extend the stay period or vary the scope of the stay as are set out in the recommendations dealing with secured creditors. During the initial stay period or any extension of the stay created by the filing of a proposal, the secured creditor should bear the onus of proving that it is not adequately secured if it seeks to have the stay period shortened. If a further extension of the stay period is sought by either the debtor or the trustee, such party should bear the onus of satisfying the court that the secured creditor is adequately secured.

43. It should be possible for a proposal to include a compromise between the debtor and all or any classes of its secured and unsecured creditors.

44. Creditors should be entitled to vote on the proposal in their respective classes. The courts should have jurisdiction before or after the meeting of creditors to determine any issues relating to the appropriateness of the classes and any other problems that may arise.

45. If at the meeting of creditors any class refused to approve the proposal by the requisite majority, the proposal in its entirety should be deemed to have been defeated; the stay should cease to apply; the debtor should be deemed bankrupt and the trustee under the proposal should become trustee in bankruptcy. The proposal could provide that the negative vote of a particular class (especially a secured class) did not automatically defeat the entire proposal or did not automatically result in a bankruptcy, providing that safeguards exist to protect against abuse.

46. The concept of court-formulated proposals as set out in Bill C-17 or the "cramdown" provisions of Chapter 11 of the United States Bankruptcy Code should not be introduced in Canada, since the problems created by them would outweigh their benefits.

47. A debtor who either intends to file or has filed a proposal should have the right to apply to the court for an order permitting the repudiation or variation of an executory contract. Such a right should only be available to a debtor seeking a reorganization and should not be available to the trustee of a bankrupt estate.

48. A debtor who seeks to have an executory contract repudiated or varied should be required to establish to the satisfaction of the court all of the following:

- o the contract between the debtor and the third party was onerous;
- o the contract was not in the best interests of the debtor and the creditors generally;
- o the existing contract rendered reorganization of the affairs of the debtor impracticable;
- o the proposed amendment to the contract was necessary for the implementation of the reorganization;
- o the proposed new contract was fair and equitable;
- o the debtor had bargained with the other party in good faith prior to seeking the assistance of the court; and
- o the other party rejected the proposed amendment to the contract "without a good cause."

49. A third party who suffers damages as a result of the repudiation or variation of a contract by the court should be entitled to a claim in the proposal for the purposes of voting and distribution.

50. If the contract is varied by the court, any affected party should have the right to rescind the contract. If the rescission is by a party other then the debtor, such party should not be entitled to a claim for any damages suffered as a result of the rescission of the contract.

51. The court should be given the power to grant relief against forfeiture.

52. The court should be given the power to cancel the contract altogether on such terms as the court may deem fit for the purpose of protecting the interests of the creditors generally, having regard to the debtor's plan of reorganization.

53. The value of the claims of creditors required to accept a proposal should be reduced from 75% to 66 2/3%. The affirmative vote of a majority of the creditors voting should still be required.

Suppliers of Merchandise

54. There should be no change in the *Bankruptcy Act* with regard to the rights of unpaid vendors. To grant special treatment to unpaid vendors would be inequitable and prejudicial to the position of other unsecured creditors.

55. Each province should retain the right (if it deems fit) to grant or maintain secured creditor status for an unpaid vendor.

Consumer Bankruptcies and Arrangements

56. The type of administration applicable to the bankruptcy of an individual should be determined by the extent of the bankrupt's liabilities.

57. A consumer debtor should be defined as a debtor whose preferred and unsecured debts do not exceed $40,000 or such other amount as may be prescribed by regulation.

58. Special provisions should apply to proposals by consumer debtors.

59. The following procedural changes should apply to a proposal filed by a consumer debtor:

- a creditor should only be required to file a proof of claim if the amount of its debt shown on the list of creditors prepared by the trustee was incorrect;
- the creditors should vote by written ballot unless creditors representing 25% of the dollar value of the debts request a meeting of creditors. All creditors should be given notice of that meeting but should be entitled to vote by voting letter at that meeting as well;
- it should only be necessary to apply for court approval of a proposal if a creditor requests a review of the proposal by the court;
- the trustee should file a certificate of compliance with the Official Receiver when a consumer debtor has fulfilled all obligations under the proposal;
- the rejection of a proposal by a consumer debtor should not result automatically in a bankruptcy; and
- a consumer proposal should not bar deficiency claims by secured creditors when they have realized on their security.

60. The amount to the credit of a bankrupt in a registered retirement savings plan up to a limit prescribed by regulation should not be divisible among the creditors of the bankrupt. The maximum amount of such exemption at the present time should be $50,000.

61. The court should be permitted to direct self-employed undischarged bankrupts to forward a portion of their earnings to their trustees for distribution among their creditors. In considering the amount of such payment the court should take into account normal business and operating expenses.

62. If a bankrupt has net earnings in excess of $40,000 after deducting all business expenses, the trustee should be required to apply to the court for an order making the discharge of the bankrupt conditional on the bankrupt paying a portion of income to the trustee for distribution among the creditors. The onus should be placed on the bankrupt to satisfy the court why such an order should not be made.

63. A consumer bankrupt should be discharged automatically nine months after the date of bankruptcy unless either:

- o a creditor files a notice of opposition to the bankrupt's discharge; or
- o the bankrupt has net earnings in excess of $40,000.

64. If a hearing of the discharge is required, it should be held before a bankruptcy court judge and the trustee should be required to prepare a report on the affairs and conduct of the bankrupt.

65. A bankrupt should be entitled to be released from any debt or liability for goods supplied as necessaries.

66. A debt or liability arising out of fraud should be released unless the debtor has been convicted of fraud under the Criminal Code.

67. A task force should be appointed to develop recommendations for amendments relating to the respective rights of the creditors of the bankrupt and the spouse of the bankrupt.

Preferred Claims

68. The priority of the Crown should be totally abolished under both federal and provincial jurisdiction, and all claims of the Crown should rank in the same priority as un-

secured creditors. The elimination of the Crown priority should include all provincial and federal legislation purporting to give priority by way of security, statutory trust or lien or otherwise for any debt not contractually incurred. The abolishment of priorities should include all Crown corporations either federal or provincial.

69. Any future Act of Parliament must make a direct reference to the *Bankruptcy Act* in order to supersede the provisions of the *Bankruptcy Act* dealing with the priority of distribution of the property of a bankrupt.

70. The priority presently attributed to funeral and testamentary expenses of a deceased bankrupt should be limited to a maximum of $5,000.

71. The administration costs of a bankruptcy, including the expenses and fees of a trustee, should rank in priority to all Crown claims, including statutory deemed trusts and liens.

72. The preferred claim of a landlord for three months' arrears of rent and three months accelerated rent should be abolished. The estate should still be responsible for payment of occupation rent as an expense of administration.

73. The legal bill of costs of the first creditor should not be given priority.

Farmers and Fishermen

74. A farmer in financial difficulty should have a choice of either:

- proceeding in accordance with the provisions set out in this paper on corporate reorganizations; or
- proceeding in accordance with provisions to be set out in a special part of the *Bankruptcy Act* for farmer's proposals.

75. A separate part of the *Bankruptcy Act*, which would only apply to farmers, should provide for a 60-day stay and a committee of financial and farming experts to assist the farmer in negotiating with the creditors and in preparing a proposal to creditors.

76. The 60-day stay period should be initiated by a farmer filing a Notice of Stay with the court and with the Official Receiver. All proceedings by secured and unsecured creditors should be stayed for 60 days subject to any creditor

applying to the court to vary or remove the stay on the basis of a material erosion in that particular creditor's rights or security.

77. Upon the filing of the Notice of Stay the debtor should be required to provide the clerk of the court with a listing of all creditors and a description of assets. The clerk of the court should notify all creditors of the stay. The clerk should also notify a farmers' advisory committee.

78. During the 60-day period the farmers' advisory committee should investigate the affairs of the farmer and meet with the farmer and the creditors.

79. The farmers' advisory committee should attempt to determine whether or not an arrangement with the creditors could be achieved. If an agreement relating to the restructuring of the financial affairs of the farmer is achieved, the committee should file a report with the court and the farmer should have the option of either filing a proposal or discontinuing the stay without filing a proposal.

80. If a proposal is filed under the proposed part dealing with farmers and if the proposal fails, the farmer should not be automatically bankrupt. There should be no further stay, however, with respect to secured creditors.

81. To encourage lending institutions not to tighten up on the amount of credit available to farmers there should be stringent penalties imposed on any farmer who fraudulently disposes of any property during the 60-day period. In addition, all secured creditors should have the option of either appointing a monitor to inspect and obtain all relevant information relating to the assets covered by their security or funding the appointment of an interim receiver to take control of the secured assets but not interfere with the carrying on of the farmer's operations.

82. If the advisory committee becomes aware of any fraudulent conveyances by the farmer during their review, the committee should be required to advise the court forthwith and the 60-day stay period should be terminated immediately.

83. A secured creditor should be required to obtain leave of the bankruptcy court before seizing all or substantially all the assets of an insolvent farmer essential for the normal conduct of the business of the farmer.

84. The definition of a farmer should be expanded to include a corporation or partnership deriving all or substantially all of its income from farming if all the shareholders or partners are individuals related to each other.

85. The provisions of this report recommending that the bankruptcy court should be given the power to stay proceedings by secured creditors should apply to secured creditors of farmers.

86. Where farmers are creditors they should be treated as any other creditors and no additional special treatment should be provided.

87. The above recommendations on farmers should also apply to fishermen.

Securities Firms, Insurance Companies and Financial Institutions

88. The previous draft legislation dealing with insolvent securities firms, which was carefully developed in close consultation with the self-regulatory organizations, should be implemented at the earliest possible date.

89. The insolvent securities firm should be administered in either of two ways. The first approach should be utilized if an insurer such as the National Contingency Fund agrees to protect all customer creditors for unlimited claims. The second would apply if the insurer declines to protect all customer creditors.

90. A brief consultation should be held with representatives of the securities industry to ensure that recently developed new products such as financial futures, options and contracts have been appropriately anticipated in the previous draft legislation and that no significant further amendments are required.

91. The proposed legislation for insolvent insurance companies is not ready for implementation at this time but should be further developed. It should be amended to reflect the realities of the problems encountered in recent insurance company insolvencies. A task force should be set up to make recommendations with regard to the appropriate amendments to both the *Bankruptcy Act* and the *Winding Up Act*.

92. A task force should be appointed to develop recommendations for proposed legislation relative to the insolvency of trust companies, loan corporations, credit unions and banks.

93. With regard to financial institutions, two separate schemes of distribution should be created, one for customers and depositors and one for other creditors. The claims of

the Crown as a depositor should not receive any preferential treatment.

International Insolvencies

94. The *Bankruptcy Act* should be amended to become more compatible with the bankruptcy legislation of other jurisdictions by making provision for international insolvencies. A foreign representative having rights and duties analogous to those of a Canadian trustee should be recognized in Canada under certain circumstances. Such recognition should be granted where a foreign court in a bankruptcy matter has made an order seeking the aid of a Canadian bankruptcy court. In such an instance the Canadian court should be entitled to exercise in regard to the matter specified in the order such jurisdiction as it could exercise in regard to similar matters within its jurisdiction.

95. Where property of a Canadian bankrupt is situated outside Canada and a creditor receives all or any part of that property, the value of the property received should be taken into account when the assets of the bankrupt in Canada are distributed. No dividend should be paid to such creditor until every other creditor has received a dividend equal to the percentage that the value of the property received by that creditor bears to the total claim of that creditor.

96. Guidelines should be provided to the court when relief is sought by a foreign representative having rights and duties analogous to those of a Canadian trustee. The court should be guided by what will best assure an economical and expeditious administration of the assets involved in the proceedings located in Canada.

97. A treaty with the United States relating to bankruptcy and insolvency matters should be considered. Special attention should be given to the factor determining the jurisdiction in which the bankruptcy should be administered and the law governing the rights of the parties.

Estate Administrative Matters

98. The taxation of the trustee's fee by the court should only be required if it is not approved by the inspectors or the creditors or if it is objected to by a creditor or other interested party.

99. A trustee should be allowed to draw advances on account of fees, subject to the approval of the inspectors, provided

that the amount to be drawn does not exceed 85% of the amounts approved by the inspectors. In special circumstances where the completion of the administration of the estate is unduly prolonged, the trustee should have the right to apply to the court for permission to draw fees up to 100% of amounts previously approved by the inspectors.

100. The aforesaid provisions should not apply to summary administration or consumer debtor bankruptcies.

101. The trustee should have the right to have its account taxed before either the registrar or a judge of the bankruptcy court.

102. The Superintendent of Bankruptcy should have the power to suspend a trustee's ability to draw interim fees on account of all estates in process.

103. If there are no inspectors or if the trustee's fee is not set at the first meeting of creditors, the trustee should be required to have its account taxed by the court.

104. If the trustee's fees are substantially upheld on a taxation initiated by an objecting creditor or other interested party, the trustee should be allowed to claim against the estate for the time spent in the preparation for taxation and the attendance at same.

105. The remuneration of the trustee should not be based on 7½% of the amount of the realization from the property of the bankrupt after secured creditors have been paid or satisfied. Such remuneration should be determined by having regard to all the circumstances, including the work done by the trustee, the responsibility imposed on the trustee, the time spent in doing the work, the reasonableness of the time expended, the necessity of doing the work and the results obtained.

106. When receivers or their legal counsel are required to tax their accounts, they should be entitled to elect to have the accounts taxed before the registrar or a judge of the bankruptcy court.

107. The taxation of legal fees of solicitors for services rendered on behalf of bankrupt estates should not be required if the accounts have been approved by the trustee and the inspectors, unless any creditor or the Superintendent of Bankruptcy objects to the amount of such legal fees.

108. The trustee should provide the inspectors with a signed statement that it has examined the bill of costs, that the

services have been duly authorized and rendered and that the charges are considered fair and reasonable.

109. If there is an objection to the amount of the legal costs, the solicitor to the estate should be required to proceed to taxation with the right to elect to appear before either the registrar or a judge of the bankruptcy court.

110. If the amount of the legal fees taxed by the court is not materially different from the amount approved by the trustee and the inspectors, the solicitor to the estate should be entitled to costs against the estate for the time spent in the preparation for and attendance at the taxation.

111. If the trustee is required to attend at the taxation of the legal costs as a result of an objection filed by a creditor or the Superintendent of Bankruptcy, the trustee should be unable to charge for the amount spent at the taxation if the court taxes down the amount previously approved by the trustee and the inspectors.

112. The solicitor to the estate should be entitled to render accounts to the trustee from time to time during the administration of the estate, and the trustee should be authorized to pay those accounts with the approval of the inspectors on the understanding that only 85% of the bills submitted should be paid until the estate administration has been completed and legal fees have finally been resolved.

113. Inspectors should be allowed a fee of $50 per inspector per meeting regardless of the amount of the net receipts of the estate.

114. No fee should be paid to inspectors in consumer bankruptcies.

115. The trustee should be entitled to convene a meeting with inspectors by a telephone conference call.

Directors' and Officers' Liability

116. The *Bankruptcy Act* should be amended by including the definition of a "responsible person." This would include an officer or director of a corporation and would extend the provisions of the *Bankruptcy Act* to cover persons who control the affairs of a bankrupt without holding official positions.

117. When a company is declared bankrupt, all responsible persons of the corporation should be jointly and severally

liable to the employees of the corporation for wages earned and expenses incurred during the period of their tenure, subject to recommendations 118 and 119 below. If such wages and expenses are paid by the wage earner protection fund and the responsible person reimburses the fund for such wages and expenses, the responsible person should be subrogated to the rights of the fund against the estate.

118. Responsible persons of a bankrupt corporation who had no management responsibility should not be liable for the payment of wages of employees if they relied in good faith on financial information relating to the affairs of the company supplied by either the management of the company or a professional person and establish that they had reasonable grounds to believe that the wages would be paid.

119. Responsible persons of a bankrupt corporation who had management responsibility should not be liable for the payment of wages of employees if they relied in good faith on financial information supplied by a professional person and establish that they had reasonable grounds to believe that the wages would be paid.

120. Where there has been wrongful conduct by a responsible person, the trustee, the Official Receiver or any interested person (including any creditor) should be entitled to apply to the court to have the responsible person disqualified from acting as a director of any corportion for such a period of time as determined by the court. If the court is satisfied that the estate suffered a financial loss as a result of such wrongful conduct, the court should be entitled to award damages in favour of the estate against the responsible person or persons. If a reviewable transaction results in a loss to the bankrupt, the responsible persons who permitted such transaction should be personally liable to the trustee for any loss resulting from the reviewable transaction.

121. A person who is a bankrupt should be disqualified from acting as a director or officer of a corporation.

Technical Amendments

122. Many technical amendments set out in the last section of this report are recommended for the purpose of improving the administration of bankrupt estates.

INTRODUCTION

The basic purposes of the *Bankruptcy Act* are to provide for the orderly and fair distribution of a bankrupt's property among its creditors and to permit an honest but unfortunate debtor to obtain a discharge from debt, subject to reasonable conditions.

The present *Bankruptcy Act* was enacted in 1949. Within a few years numerous complaints began to arise that the Act had become inefficient, obsolete and incapable of coping with fraudulent bankruptcies. As a result, the Act was amended in 1966 expanding the investigatory powers of the Superintendent of Bankruptcy, tightening the rules regarding fraudulent preferences, incorporating the concept of "related persons", and enabling trustees to deal more effectively with improper transactions by a debtor, and providing for the orderly payment of debt system in Part X.

The Study Committee on Bankruptcy and Insolvency Legislation (known as the Tassé Committee) was also appointed in 1966 to review bankruptcy and insolvency legislation in Canada. The Tassé Committee undertook an in-depth study of Canadian bankruptcy law and in 1970 published its report, recommending the enactment of a completely new bankruptcy and insolvency statute that would establish an integrated and comprehensive bankruptcy system.

From 1970 to 1984, a prolonged effort was made to enact a new bankruptcy statute. Six bankruptcy bills, largely inspired by the Tassé Committee report, were introduced into Parliament over that period. The first was Bill C-60, introduced in 1975; succeeding revisions to Bill C-60 incorporated recommendations made by the Senate Standing Committee on Banking, Trade and Commerce as well as various interested private groups. The most recent proposal, Bill C-17, was introduced in January 1984. None of these bills were enacted.

The present Minister decided that, after the failure of six previous attempts to bring about a sweeping reform of the bankruptcy system, it would be better to proceed by amending the existing Act. In March 1985, he convened this special Advisory Committee composed of trustees and lawyers from across Canada. Its mandate was to examine the bankruptcy system, assess possible reforms and recommend to the Minister amendments to the Act that would make it more flexible and bring it more into line with current conditions.

In 1984, almost 32,000 bankruptcies and proposals were recorded across Canada. They involved $4.1 billion in total liabilities: 22,022 consumer bankruptcies totalling $1.24 billion in liabilities, 9,578 commercial bankruptcies totalling $2.46 billion in liabilities, and 389 proposals totalling $355 million in liabilities. Given the amounts involved, it is clearly important for the country's social and economic well-being that the assets involved in bankruptcies be reallocated with a minimum of disruption and that individual debtors be sent on the way to rehabilitation as soon as possible. The extent to which this goal is achieved will depend largely on Canada's bankruptcy legislation.

The committee has identified and analyzed what were in its opinion the twelve important facets of bankruptcy and insolvency law that most urgently needed reexamination. They are as follows:

- Wage Earner Protection
- Requirements for Receiver and Secured Creditors
- Commercial Reorganizations
- Protection of Suppliers of Merchandise
- Consumer Bankruptcies and Arrangements
- Preferred Claims
- Rights of Farmers and Fishermen
- Securities Firms, Insurance Companies and Financial Institutions
- International Insolvencies
- Estate Administrative Matters
- Directors' and Officers' Liability
- Technical Amendments

The committee's findings in respect of these items are set out in Part IV of this report.

OBJECTIVES OF BANKRUPTCY LEGISLATION

Any proposed change to our bankruptcy legislation should be assessed in terms of how well it contributes to meeting the basic goals or objectives of the law. The committee has identified the following objectives against which proposed amendments to the *Bankruptcy Act* might be measured.

- Bankruptcy legislation should be fair and equitable. It should establish a proper equilibrium in the balance of power between the debtor, the secured creditors and the unsecured creditors. It should provide for an equitable distribution of the proceeds in a bankruptcy among the various classes of secured and unsecured creditors and at the same time assure fair treatment of debtors.

- Bankruptcy legislation should allow for effective reorganizations and support the maintenance of viable business enterprises. It should promote arrangements between consumer debtors and their creditors where practicable.

- It should facilitate the rehabilitation of debtors where feasible.

- Bankruptcy legislation should be flexible. It should be able to effectively address special needs and circumstances while considering the interests of different classes of creditors.

- In seeking to ensure fair treatment of debtors, the legislation should recognize the special circumstances of different categories of debtors. For example, the insolvencies of financial institutions (banks, trust companies, insurance companies and securities firms) create special problems which demand special treatment.

- Bankruptcy legislation should encourage commercial morality. It should prevent abuse of the bankruptcy system and treat fairly those who behave honestly in bankruptcy situations.

- Bankruptcy legislation should be understandable and administratively workable in order to provide for speedy and inexpensive liquidation of assets and discharge of bankrupts where alternatives to bankruptcy are not feasible.

SUBJECT MATTERS REQUIRING REFORM

WAGE EARNER PROTECTION

Current Law

Under Section 107(1)(d) of the *Bankruptcy Act* a wage earner is entitled to a preferred claim, in an amount not exceeding $500, for arrears of wages for services rendered during the three months prior to the bankruptcy. In addition, a travelling salesman is entitled to a preferred claim for disbursements not exceeding $300 incurred during the same period. These preferred claims rank behind the claims of all secured creditors. Various provincial statutes also provide wage protection for employees. For example, the Employment Standards Act of Ontario and the Labour Standards Code of Nova Scotia provide that amounts owing for vacation pay constitute deemed trusts and liens. The Labour Standards Code of British Columbia creates a statutory lien for unpaid wages. Similar legislation exists in Alberta, Saskatchewan, Manitoba and Newfoundland. Under Section 178(6) of the *Bank Act*, if a bank enforces security granted pursuant to that Act and a bankruptcy ensues, the arrears of wages owing to the employees for services rendered within three months prior to the date of bankruptcy rank in priority to the claim of the bank.

Problems

The present *Bankruptcy Act* does not provide satisfactory protection to employees whose employer goes bankrupt. In many instances there are insufficient assets to satisfy the claims of secured creditors, leaving no funds available to pay the claims for wages. The requirement that secured claims be satisfied first usually produces a long delay in the payment of wage claims. Provincial legislation has also been ineffective. In some cases, there is no adequate protection for arrears of wages and only vacation pay is protected. In other cases, the court has held that the deemed trusts or liens created by provincial statutes rank behind various categories of secured creditors. The determination of the respective priorities of wage claims and secured claims under provincial legislation has generated considerable litigation. The rights of employees to priority under the *Bank Act* are somewhat illusory, because they do not apply when a bank enforces a security agreement (such as a debenture) that is not covered by the *Bank Act*. Also, the employees' rights only arise when a bankruptcy has occurred; in many instances a bank will realize on its security without formal bankruptcy proceedings.

Background

The Tassé Committee's report, published in December 1970, recommended that wage claims should take priority over all other claims, including all types of secured claims. This recommendation, which has become known as "super priority," was incorporated into Bill C-60 when it was introduced into the House of Commons on May 5, 1975. It provided that a claim for wages up to a maximum of $2,000 would be entitled to be paid in full out of the assets of the bankrupt in priority to the claims of all secured creditors. In its report dated December 1975, the Senate Committee recommended that consideration be given to the creation of a government-administered fund under the authority of the *Bankruptcy Act* out of which unpaid employee wages could be paid forthwith after the bankruptcy of the employer. The claim for unpaid wages would cover wages in arrears to a limit of $2,000 and would not include vacation pay, severance pay and fringe benefits.

In Bill C-12, the employee was entitled to a preferred claim for wages up to a maximum amount of $2,000 for arrears of wages plus an additional $500 for pension plan and other employee benefits. However, the preferred claim for the wage earner would have been subordinate to the claims of secured creditors. In its report on Bill C-12, the Senate Committee reaffirmed its support for a wage earners' protection fund.

In 1981 a committee chaired by Raymond Landry, the present Dean of Law at the University of Ottawa and a former Superintendent of Bankruptcy, was asked to recommend ways of protecting wage earners in the event of their employer's bankruptcy. In its October 1981 report, the Landry Committee recommended, as an interim solution, that a wage earner protection fund be established for a period of three years. It would pay claims for arrears of wages up to a maximum of $1,000 and would be financed from the Consolidated Revenue Fund.

Bill C-17, which received its first reading in the House of Commons on January 31, 1984, contained basically the same provisions for wage earners as Bill C-12. However, amendments tabled on May 28, 1984 provided that in the event of a bankruptcy or receivership, a claim for wages up to a maximum of $4,000 would rank in priority to the claims of all secured creditors.

Other Jurisdictions

Province of Manitoba

The Province of Manitoba has created a fund, called the Payment of Wages Fund, under the *Payment of Wages Act*. The fund may pay to an employee, in respect of unpaid wages, an amount not exceeding $1,200 per calendar year. The fund will apply when wages remain unpaid although all reasonable and necessary efforts have been made to collect them. When the employee has received money from the fund the Director of the Employment Standards Division of the Ministry of Labour and Manpower can institute proceedings against the employer to recover the amount of the unpaid wages. In the fiscal year 1984-1985 the following moneys were advanced to unpaid wage earners from the Payment of Wages Fund.

Fiscal Year - April 1984 to March 1985

	Number of Employers	Number of Employees	Amount Paid	Amount Recovered
Bankruptcies	20	177	$ 84,722.53	$ 81,292.77
Receivership	19	309	189,328.94	135,918.71
Closures	72	238	114,035.78	12,572.14
Business Still Operating	21	41	23,661.38	9,199.18
Total	132	765	$411,748.63	$238,982.80

Construction Board of Quebec

In 1975, the Construction Board of Quebec created a fund to protect the construction employees under the *Loi sur les relations de travail dans l'industrie de la construction* (L.R.Q.C.R.20). The fund provides protection for all employees working in the construction industry for payment of wages, in cases of bankruptcy, insolvency, liquidation, or in a proposal. The fund is financed by the employer (two cents an hour worked per employee).

Province of Ontario

The final report of the Commission of Inquiry into Wage Protection in Insolvency Situations was recently submitted to the Minister of Labour of Ontario by

Mr. Donald J.M. Brown, Q.C., Commissioner. Although the Committee has not had adequate time to fully study this report, its recommendations included inter alia that:

- o A fund be established, to be administered by the Director of Employment Standards of the Province of Ontario, out of which claims of employees for unpaid wages and vacation pay should be paid.

- o The limit to claims from such a fund should be one-year's accrued vacation pay and three pay periods of unpaid wages.

- o Separation and termination pay claims should not be reimbursed by the fund.

- o The fund should be financed by the Consolidated Revenue Fund of the Province of Ontario or alternatively by increasing the Personal Property Security Act registration fees for non-consumer security registrations.

- o The Director of Employment Standards should be empowered to licence or authorize trustees in bankruptcy to act as his agent to facilitate speedy payments of unpaid wages.

In addition, the study concluded the following:

1. Ideally, the federal government should accept responsibility for legislation relating to wage protection in insolvency situations. In the absence of federal action, however, a province does have legislative competence and has open to it most of the techniques necessary to ensure that employees do not bear the loss of unpaid wages.

2. In many instances, the present laws are ineffective in protecting employees from unpaid wages, and a wide cash flow gap exists since unemployment insurance does not commence from the date of the last wage payment; rather, the "waiting period" of two weeks commences with the first day of unemployment.

3. The extent of unpaid wages in 1982 - 83 was estimated to be not more than six million dollars, excluding unpaid fringe benefits, severance and termination payments not made. While this figure, even if an estimate is added for unpaid fringe benefits, is relatively minor when viewed from the perspective of the annual budget of the Province,

its impact on the individuals affected was substantial.

European Countries

A number of the largest countries in Western Europe, including England, France and Germany, have recognized the need to protect employees upon the insolvency of their employer. Each of them has determined that the most effective method of providing this protection is by the establishment of a wage earner protection fund. A summary of the employees entitled to protection, the coverage afforded by each of the funds and the costs associated with such funds is set out in Table 1. Our investigation has determined that the major problems resulting from the fund are administrative ones. However, they appear to have been overcome in those cases where the trustee of the insolvent employer is responsible for filing the claims and distributing the payments to the employees. In each instance, the annual contribution per employee is a relatively low amount; in Denmark, for example, it was $5 in 1984. This was the case even though coverage under the fund included severance pay and the maximum payment per claim was $8,700.

In England, with a population of 56,400,000 and a work force of 18,800,000, the authorities are budgeting in the 1985-86 fiscal period for 70,000 claims totalling £42,000,000 ($84,000,000). Thus, the cost per employee would be £2.23 ($5). In England the maximum payment out of the fund per claim for arrears of wages and holiday pay is £2,156 (approximately $3,780). In addition, payments of up to £1,848 (approximately $3,240) are permitted for severance pay.

In Germany the wage earner protection fund is administered by the Unemployment Insurance Fund. In 1984, with a population of 62,000,000, there were 166,987 claims aggregating 665,000,000 DM (approximately $345,000,000). The fund covers three months' arrears of wages and fringe benefits with no maximum limit on a claim.

Policy Considerations

To the fullest extent possible, the provisions of the *Bankruptcy Act* should protect the rights of employees to any amount owed them by their bankrupt employer. Payment of such claims should be both certain and prompt. The administration of any system for the payment of the claims should be simple and inexpensive. Any priority attributed to wage claims should not severely prejudice the availability of credit to business enterprises in Canada.

WAGE EARNER PROTECTION FUND EUROPEAN COUNTRIES

	BELGIUM	DENMARK	UNITED-KINGDOM	FRANCE	GERMANY	NETHERLANDS	ITALY *
EMPLOYEES ENTITLED TO PROTECTION	all employees	all employees	all employees except: 1 public servants 2 fishermen 3 merchant marine 4 spouse of employer	all employees except: 1 public servants 2 professionals	all employees	all employees	all employees except public servants
COVERAGE							
A) ARREARS OF WAGES	yes (2 months)	yes	yes (8 weeks) £154 weekly ($270)	yes (60 days)	yes (3 months)	yes (13 weeks)	yes (6 months)
B) HOLIDAY PAY	yes (2 months)	yes (no maximum)	yes (6 weeks) £154 weekly ($270)	yes	yes	yes (one year)	yes
C) SEVERANCE PAY	yes 3,300 BF ($75.) per year of employment indexed	yes	yes (12 weeks) £154 weekly ($270)	yes	yes	yes	yes, 1 month of wages/year of employment
MAXIMUM PAYMENT	900,000 BF ($20,628)	60,000 kroners net after taxes ($7,716)	£2156 for arrears of wages and holiday pay ($3,780)	maximum amount not available	No maximum amount	No maximum amount	80% of wages for 36 months following bankruptcy
ADMINISTRATION							
A) RESPONSIBILITY FOR FILING CLAIMS	employee or trustee	employee	trustee or receiver	trustee	trustee or employee	employee	employee
B) RECIPIENT OF CLAIM	employee	employee	trustee or receiver and rarely to the employee	trustee	employee	employee	employee
C) PAYER OF CLAIM	Fonds d'indemnisation des travailleurs licenciés en cas de fermeture d'entreprise	L.G. - Employees Guarantee Fund	Department of Employment (National Insurance Fund)	A.G.S. Assurance de garantie des salaires	Federal Employment Institute	Industrial Board	I.N.P.S. (Social Security Program)

TIME PERIODS							
FILING CLAIM	15 days from bankruptcy	4 weeks with possible exemption	not available	10 days for wages and 3 months for others	about 2 months but extension for further 2 months possible	not available	15 days after bankruptcy
PAYMENT OF CLAIM	6 months (during that period employee receives U.I.)	3 to 4 weeks	about 6 to 8 weeks after filing of claim	5 days (wages)	minimum: 2 weeks maximum: 2 months	4 weeks average	60 days
FINANCING OF FUND	employers	employers	employers & employees	employers	employers	employers and employees	employers
POPULATION (1984)	9,840,000	5,100,000	56,400,000	54,346,000	62,000,000	14,000,000	57,000,000
CLAIMS PAID	1983 28,603 claims	1983 22,000 claims	1983-84: 80,000 claims 1985-86: 70,000 claims (forecast) 1986-87: 65,000 claims (forecast)	since 1973 80,000 claims	1984: 166,987 claims	not available	1982-1984 20,500 claims settled
TOTAL ANNUAL PAYMENT FROM FUND	1983 3.391 billion BF ($82.5M)	1983 137 million kroners ($18.6M)	1985/86: £50 million ($100M)	since 1973 23 billion FF ($3.8B)	1984: 665,000,000DM ($345,000,000	not available	1984 3.7B lires ($2.7M)
ANNUAL CONTRIBUTION PER EMPLOYEE	(1985) 0.74% of gross wages (for business of more than 20 employees, 0.52% (for business less than 20)	1984 $5.00 per employee	employer: 0.3% of gross wages employee: 0.15% of gross wages	1984 0.35% (gross wages)	employer: 0.12% of the payroll	1984 0.56% of gross wages per employer 0.56% of gross wages per employee	1985 0.03% of total monthly payroll

* In Italy, the arrears of wages and holiday pay are covered by a separate legislation while the severance pay is covered by the fund.

Solutions

Super Priority

One potential solution is super priority, which involves granting wage claims priority over all other claims, including all types of secured claims. This solution has the advantage of not involving any government funding or the establishment of any form of administrative system to pay the claims. The courts would deal with any disputes or problems.

Under super priority there is no absolute certainty that the wages owed by the bankrupt will be paid. The available assets of the bankrupt may not cover the amount claimed. There may also be a significant delay in the payment of wage claims, because the sale of the bankrupt's assets may occupy a lengthy period of time. It has been proposed that the trustee of the bankrupt estate should be empowered to borrow funds for the purpose of paying the claims of wage earners. However, the assets of the bankrupt may not be readily convertible into cash and a lender may be reluctant to make loans against them. The time required to satisfy a lender as to the realizable value of the assets may also delay payment of wage claims.

Serious difficulties may arise in the administration of the super priority proposal, such as the allocation of the burden among the secured creditors. A very complicated formula for allocating the liability to pay wage claims will be necessary. It has been suggested that the trustee should be entitled to use moneys on hand or in a bank or other depository to pay wages. If additional moneys are required, the trustee should also be entitled to borrow money and grant to the lender of that money a security interest in all or any part of the property of the bankrupt, whether or not the property is subject to an existing security interest. Such borrowing would then rank ahead of claims of all other secured creditors.

In principle, this sounds very simple. However, it must be realized that there are many different types of security interests, and the allocation of the burden of paying wage claims among the various secured creditors is a complicated task. The courts will be clogged with cases attempting to determine the respective priorities of various classes of secured creditors. According to the complicated formula proposed, it would be necessary to determine the amount that was in fact realized from the assets (or the amount that was deemed to be realized from the assets) in respect to the particular property. This means that whether

or not an asset had been sold, it would have to be evaluated, which may be extremely difficult in the case of unmarketable assets.

The creation of a super priority may impose an unexpected burden on a secured creditor. The mortgagee of a property originally used as a warehouse but then converted to a labour-intensive business facility may find that the claims of unpaid employees take precedence over its mortgage. Super priority, as proposed, would impose a burden on many small secured creditors, such as an electrician who may file a mechanics' lien for moneys owing to him by a contractor or a garageman who has repaired a truck owned by a bankrupt. It is anticipated that super priority will reduce the credit available to a labour-intensive industry. If super priority is enacted into law, a lender who normally advances against fixed assets such as buildings and equipment will take into account the possibility of wages being unpaid in the event of a bankruptcy before determining the amount of credit to be extended.

Modified Priority

It has been proposed that wage earners be granted modified priority for their unpaid claims in the event of a bankruptcy. This would involve granting the wage earner a statutory priority for arrears of wages that would rank in priority to the claims of secured creditors holding security on the current assets of the bankrupt, these being assets that would normally be realized within one year, such as cash, temporary investments, inventory and receivables. Like super priority, this solution does not involve any government funding or the creation of an administrative body to supervise its implementation, and all disputes would be dealt with by the courts. The administrative problems of dealing with priority would be reduced, since fewer creditors take security on current assets.

The modified priority proposal however has problems similar to those of super priority. Paying wage claims out of current assets, which may be of limited realizable value, would reduce the likelihood of payment. This problem could arise in the case of a construction company or a courier service. There may also be a greater delay in payment of wage claims. After a bankruptcy, accounts receivable are difficult to collect for many reasons, including the fact that warranty service may be unavailable. In addition, an inventory of partially manufactured goods may be difficult to sell at a reasonable price. With only accounts receivable and inventory available as security, a lender may be reluctant to advance funds to pay wage claims.

Wage Earner Protection Fund

Another solution is the establishment of a wage earner protection fund from which to pay the claims of unpaid employees of an insolvent employer. The creation of such a fund would ensure the prompt, certain payment of the employees' wage claims. To avoid the creation of a new bureaucracy, an existing administrative system could be used. The trustee of the bankrupt estate or the receiver could perform the same duties as those required of them under the present *Bankruptcy* Act when funds are available for distribution to employees of a bankrupt company. The unnecessary time-consuming and expensive litigation resulting from the problem of allocation and priority would be avoided.

The major deterrent to the implementation of a wage earner protection fund has been a lack of consensus on how the fund should be financed, chiefly because there are no reliable Canadian estimates of potential claims. However, the committee has reviewed the total amounts of claims paid by the funds established in the European countries and is of the opinion that the financial experience of such funds provided a realistic basis for estimating the amount of the Canadian claims which would be made against a wage earner protection fund.

There have been various alternatives suggested for financing such a fund. Some of these are as follows:

- o contributions from all employers based on the number of employees;
- o contributions from employees;
- o payment out of the Consolidated Revenue Fund;
- o a levy on secured transactions when security is placed;
- o a levy on the gross realization by all creditors after a bankruptcy or receivership has occurred.

Contributions by employers

The obligation to pay wages is that of the employer. It is only because an employer has failed to meet its obligation that the fund will be called upon to pay the wages of employees. Since it is impossible to determine in advance which employer will fail, it is fair and equitable that all employers should be required to make a modest contribution to the wage earner protection fund.

Contributions by employees

The purpose of a wage earner protection fund is to provide protection for employees. Since they are the beneficiaries of the fund, it is also fair and equitable that employees be required to make a modest contribution to the fund.

Payment out of the Consolidated Revenue Fund

This involves financing the fund from the general revenue pool of the government at a time when the government is attempting to reduce the deficit.

Levy on secured transactions

Such a levy could be applied to the taking of security such as debentures, mortgages and conditional sale contracts when such security is taken. Whether it would be constitutionally correct for the federal government to impose such a levy is a significant legal question.

Levy on gross realization by all creditors, secured and unsecured

In the event of a bankruptcy or a receivership a statutory levy could be imposed on the realization by all creditors, secured and unsecured. Any creditor realizing the assets of the debtor would be required to make a payment to the Superintendent of Bankruptcy to finance the wage earner protection fund. A secured creditor would be entitled to receive the full amount of its claim plus the levy if there was sufficient value in the property subject to the security.

Miscellaneous

Other issues relating to wage priority must also be resolved. These are:

- who is included in the definition of "employee";
- which type of claim should be granted priority;
- should there be a time limit restricting the claims entitled to priority;
- what should be the maximum amount of the priority claim;

- should the priority claim include claims for vacation pay, pension and other employee benefits; and

- should severance pay be granted priority?

Recommendations

Wage Earner Protection Fund

It is recommended that a wage earner protection fund be established because no other solution ensures prompt and certain payment to employees. The fund should be financed by contributions from employers and employees. Such financing spreads the burden of paying the claims of employees among all employers and employees and avoids any impact on a particular lender. A lender to a labour-intensive industry would not deem it necessary to restrict the amount of credit it would otherwise extend. Thus there would be no impact on current lending practices.

Specific Details

Definition of "employee"

The definition should include an individual (other than a related party as defined in sections 108(2), 109 and 110 of the *Bankruptcy Act*) who is employed by or was, or has been, on the payroll of the insolvent employer prior to the date of the bankruptcy and should include sales agents who are on the payroll of the company.

Monetary entitlement

The employee as defined above should be entitled to the following:

- arrears of gross salaries, commission and wages earned within the six months preceding the insolvency;

- arrears of vacation pay earned within the 12 months preceding the insolvency;

- arrears of all amounts withheld from the employee such as pension benefits and union dues,

the whole to a maximum of $2,000 per employee; and

- arrears of expenses incurred by the employee on behalf of the employer to a maximum of $1,000 per employee in the two months preceding the insolvency.

Administration of the Fund

The fund established by the government should be administered by the Unemployment Insurance section of the Department of Employment and Immigration.

Bankruptcy

In the event of a bankruptcy where a receiver has not been previously appointed, the trustee should be required to prepare a special preferred claim on behalf of all employees. The trustee should then determine whether the assets that are not subject to claims of secured creditors would immediately realize sufficient funds to satisfy the proof of claim. If so, there would be no claim against the government fund. If, in the trustee's opinion, the assets would not be sufficient for an immediate realization to pay the special preferred claim of the employees, a proof of claim should be filed with the Unemployment Insurance section, which should forward to the trustee sufficient funds to cover the amounts owed to the employees. The trustee should effect immediate payment to the employees, making such normal deductions as income tax, unemployment insurance and pension benefits. The trustee, as the available assets of the bankruptcy are realized, should be obliged to reimburse the fund after payment of the trustee's fees and other expenses of administration.

Receivership

In the event of the appointment of a receiver, the receiver should immediately be obliged to prepare a special preferred claim on behalf of all employees. This claim should be filed with the Unemployment Insurance section, which should forward to the receiver sufficient funds to cover the amounts owed to the employees.

Payment of Costs of Trustee or Receiver

The fees and expenses of the trustee or receiver resulting from processing the special preferred claims of the wage earners should also be paid by the fund. The amount of such fees should be set on a sliding scale by regulation.

Financing of the fund

Contributions to the wage earner protection fund should be collected monthly from employers and employees. Although in the European countries the financing is largely accomplished through contributions by employers only, it is our view that the employees, as the beneficiaries of this system, should contribute their faire share.

The ultimate objective will be to have a fund which is self-financing. Funding should come from monthly contributions of employers and employees, recoveries by the fund as a special preferred status creditor under Section 107 of the Bankruptcy Act and recoveries from directors in specified limited circumstances. Based on the experiences of other countries, it is clear that there is a wide variance in claims experience which results from differences between countries in the details of each wage protection plan and wide swings which have occurred in economic conditions. In reviewing all available information, we would not anticipate that claims against such a fund would exceed $50 million on an annual basis. It would be our recommendation that this target funding from employer and employee contributions be arranged at the outset to be adjusted up or down based on subsequent experience. As there are approximately 12,100,000 employees in Canada at the present time and assuming that the contributions were split on a 50 - 50 basis between employers and employees, this would result in an additional per employee charge of approximately $2.07 per annum.

To minimize the impact on any particular employer or employee, we recommend that all employees and employers, including governments, contribute to the fund.

As previously noted, the fund should be subrogated as a special preferred status creditor under Section 107 of the Bankruptcy Act ranking immediately after the costs of administration. This, together with any recoveries from directors as proposed in the section dealing with directors' and officers' liability, will reduce the amounts which employers and employees will be required to contribute to the fund.

Severance Pay

The committee recommends that amounts due to employees for severance pay remain as unsecured claims ranking with other unsecured claims of the bankrupt, notwithstanding any provincial legislation to the contrary. There should be no special preferred status for severance pay claims, since granting such status would increase the contributions to the wage earner protection fund, and reduce the assets available for distribution to other creditors.

RECEIVERS AND SECURED CREDITORS

Current Law

Appointment of Receiver or Agent

A common and very effective method of enforcing a security interest is the appointment of a receiver or agent to take possession of and sell all the assets of a debtor that are subject to the security interest. In the common law provinces there are two ways a receiver may be appointed. One method is by instrument in writing; such a receiver is called a privately-appointed receiver. A secured creditor has the right to make such an appointment if it is authorized by the security agreement. Receivers may also be appointed by court order, if the court is granted such power by statute. Most provinces have enacted statutes entitling the court to appoint a receiver when it is just and convenient to do so. In addition, Part VII of the *Canada Business Corporations Act* authorizes the appointment of a receiver of a corporation subject to that Act. The Quebec Civil Code does not recognize the term "receiver"; however, a similar function is performed by an agent appointed by a trustee under a trust deed issued pursuant to the *Special Corporate Powers Act* of Quebec or by an agent appointed by a bank to enforce security granted under Section 178 of the *Banks and Banking Law Revision Act*. For the purposes of this report the term receiver shall also mean such an agent.

Enforcement of Security

There is currently no federal legislation governing the enforcement of security against insolvent debtors and very little provincial legislation governing such enforcement. Under the present *Bankruptcy Act*, proceedings by secured creditors are not automatically stayed by a bankruptcy or proposal. Although under Section 49(2) of the *Bankruptcy Act* the trustee of a bankrupt estate has the power to apply to the court for an order staying proceedings by a secured creditor for a period not exceeding six months, the courts have been very reluctant to make such an order if there is any adverse effect on the rights of the secured creditor. The failure of a secured creditor to receive a payment of interest on the date it was due has been a sufficient ground for the refusal of such an order, even though the secured creditor acknowledged that the assets subject to the security had a value of almost double the debt owing to the secured creditor. The only impediment to a secured creditor taking immediate possession of the assets subject to its security has been the decision of the Supreme Court of Canada in the case of *Lister (R.E.) Ltd.* v. *Dunlop Canada*

Ltd. (1982), 41 C.B.R. (N.S.) 272, which held that when a creditor makes a demand for payment, the debtor must be given a reasonable time to make payment of the amount due before the security may be enforced.

Duties of Secured Creditors and Receivers

No provisions exist in the *Bankruptcy Act* to govern the conduct of secured creditors and receivers; the only protection for debtors has been afforded by the courts. There have been a series of cases dealing with the standard of care that must be shown by a receiver or secured creditor when selling the assets of the debtor. As a result of the lack of legislation and a variety of cases based on different facts, the law governing the conduct of secured creditors and receivers is very vague and uncertain. A private receiver is only required to account to the secured creditor who made the appointment. There are no provisions requiring consultation with the unsecured creditors or the debtor as to the method of realizing the maximum amount from the assets of the debtor. After the assets have been realized, the receiver is not obliged to supply any information to the unsecured creditors or the debtor, although many receivers voluntarily provide this information. It is possible for a debtor, a judgment creditor or a subsequent encumbrancer to compel the disclosure of information by commencing an action for an accounting against the secured creditor. However, such a legal proceeding is very expensive and time consuming.

Review of Accounts

In most cases where a private receiver is appointed, there is no summary or expeditious procedure available whereby a subsequent encumbrancer, an unsecured creditor, the trustee of a bankrupt estate or a debtor may require the private receiver to have its accounts approved by the court. The usual remedy in such situations is to start a court action for an accounting.

Conflict of Interest

The *Bankruptcy Act* does not directly prohibit a person involved in the administration of an estate from occupying a position of conflict of interest. The only relevant provisions are those such as (a) the prohibition of a party to a contested action or proceeding by or against the estate being appointed as inspector and (b) the prohibition against an inspector acquiring directly or indirectly without the permission of the court any of the property of the estate.

Problems

No Restraint on Enforcement of Security

Since there is no effective restraint on the enforcement of security, the secured creditor and its receiver are the parties who determine the method and timing of the liquidation of the property of an insolvent debtor. It is obvious that an immediate cessation and liquidation of the business of a debtor precludes a reorganization of its affairs. The debtor is not given any opportunity to establish that it could carry on its business and recover a larger amount for all parties involved.

Improper Conduct of Receivers

A common but generally erroneous perception is that the secured creditor and the private receiver are only interested in realizing an amount sufficient to satisfy the outstanding debt; they do not attempt to realize a surplus for distribution to the unsecured creditors and the debtor. This perception arises from the fact that there are conflicting interests. A forced sale by a secured creditor will almost inevitably fail to bring the best possible price, for this may only be obtained at a private sale under the debtor's control. Nevertheless, the creditor is required to act honestly and in good faith and to deal with the property in a timely and appropriate manner having regard to the nature of the property and the interest of the debtor. It must be recognized, however, that the creditor should control the sale, not the debtor who would not have wished the sale in the first place. Since there has been default and interest arrears are accumulating, the creditor has a right to recover expeditiously whatever can reasonably be obtained from the assets without incurring the additional expense that a private owner might invest in order to recover the maximum return on the property.

Lack of Information

A common complaint by both the unsecured creditors and the debtor is that they are not consulted prior to the liquidation of the assets. In some cases the unsecured creditors and the debtor are given no information concerning the receivership. In fact, some receivers do not even notify the creditors of their appointment.

No Summary Method for Review of Accounts

The commencement of a court action against a secured creditor or a receiver for an accounting involves considerable expense and does not permit these issues to be resolved promptly.

Conflict of Interest

In 1970 the report of the Study Committee on Bankruptcy and Insolvency Legislation stated that:

> "Conflict of Interest: Some of the most serious and pervasive weaknesses of the system relate to the numerous situations of conflicts of interest that proliferate the bankruptcy administration and that, generally speaking, the law fails to recognize. Even the best system would suffer from the distortions brought about by the various unregulated conflicts of interest in which those who have key roles to play find themselves."

The accountant or auditor of the debtor is not precluded by the Act from being a trustee in bankruptcy or a receiver of the debtor. A trustee responsible for the liquidation of an estate for the benefit of the unsecured creditors often acts in the same matter as a receiver or agent for a secured creditor. In such a case, a trustee who is required to attack the security agreement has been placed in a potential conflict-of-interest situation.

General Recommendation

The *Bankruptcy Act* should be amended for the purpose of controlling the appointment and conduct of a receiver where there is an insolvent debtor, whether or not the debtor is formally adjudged bankrupt. Under Section 92, Head 13 of the *British North America Act, 1867*, the provinces have the right to legislate with respect to property and civil rights. However, Section 91, Head 21 of the *British North America Act, 1867* gives the Parliament of Canada the sole competence to legislate with respect to bankruptcy and insolvency. It is the committee's opinion that legislation affecting the rights and obligations of an insolvent debtor and its creditors comes within the power granted to the federal Parliament by Section 91, Head 21 of the *British North America Act, 1867*. Thus the federal Parliament has the right to amend the *Bankruptcy Act* in order to deal with the enforcement of security against the property owned by insolvent debtors whether or not such debtors have been declared bankrupt. The following definitions should be added to the *Bankruptcy Act*.

- "receiver" means a person including a receiver-manager, sequestrator, a trustee under a trust indenture, a secured creditor or any person authorized to act on its behalf who proposes to take or has taken possession or control under a security agreement or

pursuant to an order of any court, of all or substantially all of the property of the debtor essential for the normal conduct of the business of the debtor.

- o "monitor" means a person who is appointed by a secured creditor to review the affairs of the debtor and to report thereon to the secured creditor.

Specific Recommendations

Problem of No Restraint on Enforcement of Security

Appointment of receiver - proposed solutions

Three solutions have been proposed for the problems arising from the fact that there is no restraint on enforcement of security under the present *Bankruptcy Act*. These are:

Option A - requiring the secured creditor to obtain leave of the bankruptcy court to appoint a receiver;

Option B - requiring all receivers to be appointed by the court;

Option C - requiring the secured creditor to give 15 days' notice of its intention to appoint a receiver.

Option A - Appointment by Secured Creditor with Leave of Bankruptcy Court

Method of appointment: Any secured creditor who is entitled to take possession or control under a security agreement or to appoint a receiver of property of an insolvent debtor essential to the normal conduct of the debtor's business would be required to obtain leave of the bankruptcy court before so doing unless such creditor applies for the appointment of a receiver under provincial legislation. To obtain such leave the secured creditor would be required to prove the following facts:

- o the debtor was in default under the terms of the security agreement;
- o under the terms of the security agreement the secured creditor was entitled to have a receiver appointed; and
- o the debtor was insolvent.

If the first two above facts were proven, the debtor would be presumed prima facie to be insolvent. However, the

debtor would be entitled to adduce evidence to rebut the presumption. If the debtor were successful in rebutting the presumption the secured creditor would be entitled to enforce its security in accordance with provincial law, and none of the provisions of the *Bankruptcy Act* (including the statutory stay of proceedings) would apply to any subsequent receivership.

The secured creditor would be required to serve a petition for such leave at least eight days before the return of the petition. If urgency were shown, the court would have the power to abridge the eight days' notice. If the petition for leave was not opposed the matter would be heard by the registrar. Should there be opposition the registrar would be required to adjourn the matter to be heard by a judge no later than seven days after the original date for the return of the petition unless the parties consented to a later date. The right to an immediate court hearing of the matter is very important. The debtor may want the matter heard promptly in order to remove the stigma and problems created by a pending receivership petition. The creditor will want the assets protected in order to prevent further dissipation.

In some jurisdictions, crowded court dockets prevent insolvency matters from being heard promptly. To avoid this and the losses that may result from delay, the *Bankruptcy Act* should be amended to require the Chief Justice of each province to designate one or more judges to be available at least weekly to hear bankruptcy and insolvency matters. A dispute relating to the appointment of a receiver and the right of a creditor to take possession and protect assets subject to its security must be dealt with in a timely matter.

If the debtor disputes the petition, the secured creditor may request that the court appoint an interim receiver. In such a case the court should appoint the interim receiver unless the debtor satisfies the court that the secured creditor is adequately secured and there will be no deterioration in the position of the secured creditor.

Stay of proceedings by other creditors: Proceedings by other creditors would not be automatically stayed.

Qualifications of receiver: Only a licensed trustee would be entitled to act as a receiver.

Powers of receiver: The receiver, when appointed, would exercise the powers granted to it by the security agreement.

Duty of receiver: The receiver would represent the interests of the secured creditor subject to such duties as may be imposed by the *Bankruptcy Act*.

Court-appointed receivers under provincial legislation: There would be no change with respect to the appointment of a receiver by the court under provincial legislation. The time periods and procedures stipulated by provincial legislation would apply.

Option B - Appointment by the Court

Method of appointment: Any secured party who intends to take possession or control under its security agreement of property of an insolvent debtor essential to the normal conduct of the debtor's business would be required to have a receiver appointed by the bankruptcy court. No private appointment would be permitted. The same procedure as set out in Option A would apply to the timing and method of appointment of the receiver.

Stay of proceedings by other creditors: Upon the appointment of a receiver by the court, all proceedings by other creditors, secured or unsecured, would be stayed. Without limiting the generality of the foregoing, such a stay would suspend a landlord's right of seizure and any proceedings to enforce the rights of an unpaid vendor and the Crown.

Qualifications of receiver: Only a licensed trustee could act as a receiver.

Powers of receiver: The *Bankruptcy Act* would be amended to give specific powers to such a receiver. Those powers would be similar to the powers given to a trustee of a bankrupt estate under sections 12, 13 and 14 of the present *Bankruptcy Act*. However, rather than being exercised by the trustee with the approval of inspectors appointed by the unsecured creditors, such powers would be exercised by the receiver with the approval of the secured party. All receivers would be entitled to exercise the powers granted by the statute unless the court otherwise ordered.

Duty of receiver: The receiver would represent the interests of the secured creditor subject to such duties as may be imposed by the *Bankruptcy Act*.

Court-appointed receivers under provincial legislation: A court under provincial legislation would be prohibited from appointing a receiver of the assets of an insolvent debtor.

Option C - Appointment by a Creditor

Method of appointment: Any secured party who intends to take possession or control under its security agreement of all or substantially all of the property or inventory of an insolvent debtor would be required to give the debtor 15 days' notice of its intention. During the notice period the debtor would have the right to file a Notice of Stay, pursuant to the recommendations in the following section dealing with commercial reorganizations. If the debtor had grounds for opposing the enforcement of the security it would rely on rights granted by provincial law to do so, and the bankruptcy court would not be involved. The receiver would be required to file notice of its appointment with the official receiver.

Stay of proceedings by other creditors: Proceedings by other creditors would not be stayed.

Qualifications of receiver: Only a licensed trustee could act as a receiver.

Powers of receiver: The receiver when appointed would exercise the powers granted to it by the security agreement.

Duty of receiver: The receiver would represent the interests of the secured creditor subject to such duties as may be imposed by the *Bankruptcy Act*.

Court-appointed receivers under provincial legislation: There would be no change in the appointment of receivers by a court under provincial legislation. The time periods and procedures stipulated by provincial legislation would apply.

General comment

In all three cases the statute would set out the normal length of the period of notice for the appointment of a receiver, thus permitting both the secured creditor and the debtor to ascertain their rights with more certainty than now exists. If there were special circumstances, the court would have the right to abridge or extend all time periods affecting the rights of receivers and secured creditors. This would avoid the problem of a lengthy lawsuit after the fact to determine with the benefit of 20/20 hindsight whether the debtor was given a reasonable opportunity to pay the amount demanded. It would also permit the debtor with a moderate chance of obtaining refinancing to attempt to do so without having its business destroyed.

Comments on option A

Under this option the bankruptcy court is only involved in the determination of whether the security should be enforced. Thereafter all the rights of the parties are governed by the provisions of the security agreements and provincial law, subject to the provisions of the *Bankruptcy Act* requiring receivers to supply information to the creditors. The distinction between private and court-appointed receivers would be maintained. There would be no attempt to create uniformity of practice and procedure on a national basis with respect to the various types of security agreements and the various methods of enforcing security throughout Canada. Any delay in obtaining a hearing by the court and an adjudication of the issues could seriously prejudice the rights of the secured party. This must be avoided by ensuring that sufficient judges are available to resolve disputes expeditiously.

Comments on option B

The procedure outlined would be very similar to the current system where a petition in bankruptcy is filed, the debtor is declared bankrupt and a trustee is appointed. As soon as the debtor was found to be insolvent, the provisions of the *Bankruptcy Act* would govern the administration of the debtor's property. Such administration would be open to greater public scrutiny. Similarly, any delay in obtaining a court hearing could prejudice the rights of the secured party. The powers and duties of the receiver would be set out in the *Bankruptcy Act* rather than in the order appointing the receiver. Otherwise the procedures would be very similar to those presently followed when there is a court-appointed receiver.

Comments on option C

The bankruptcy court would not deal with the issue of whether the secured party was entitled to enforce its security: that would be left to the provincial civil courts. The notice of intention to appoint a receiver would not appear on the public record. The matter would only be made public when the receiver filed notice of its appointment with the Official Receiver.

Recommendations

The committee recommends the adoption of Option A. This option gives the rights of both parties better protection by requiring a court adjudication before a receiver is appointed. The debtor is given an opportunity to have a court hearing before any property is seized. The creditor

obtains an immediate decision confirming its right to appoint a receiver and avoiding a subsequent lawsuit over the issue. The current problem of what constitutes reasonable notice of the creditor's intention to enforce this security is resolved before the receiver enters into possession. The appointment of the receiver becomes a matter of public record, and all creditors are able to ascertain the status of the debtor's affairs. The fact that the receiver is only able to exercise the powers granted to it by the security agreement authorizing the appointment ensures flexibility, since it permits the security agreement to set out the most appropriate method of realizing upon the particular type of security subject to the agreement. It avoids the necessity of establishing a uniform code of practice and procedure throughout the country.

For the above reasons, a significant majority of the committee supported Option A. However, certain members expressed serious concern that Option A would not function effectively because of the inability of the secured creditor to have its application dealt with expeditiously by the court due to the unavailability of judges. It is trite to point out that timely adjudication is an essential element of an effective bankruptcy system in Canada. Since the administration of the judicial system dealing with bankruptcy matters is the responsibility of each province, it is very important that there be consultation with each province relating to the proposed amendments to the *Bankruptcy Act* to ensure that the court system will have sufficient personnel to efficiently handle bankruptcy matters.

Recommendations

Automatic stay on sales out of ordinary course of business and removal of property: The right of a secured creditor or receiver to sell any property of the debtor out of its ordinary course of business or to remove it from the debtor's premises should be stayed for a period of 21 days after the receiver has been appointed, unless leave of the court is obtained. During that period the receiver should be entitled to exercise the following powers:

- to take possession of the property of the debtor but not to remove it from the debtor's premises;
- to collect accounts receivable;
- to sell property that is perishable or likely to depreciate rapidly in value;
- to carry on the business of the debtor;

- o to solicit but not accept offers to purchase the assets.

Variation of stay by court prior to appointment of a trustee in bankruptcy: Upon the application of the secured creditor the court should have the power to shorten the stay. On such an application the secured creditor should bear the onus of proving that it was not adequately secured. Upon the application of the debtor, the trustee acting under a proposal, another receiver or any creditor, the court should have the power to extend the stay period or to broaden the terms imposed on the receiver or secured creditor. An example of such an extension would be prohibiting the secured creditor from taking possession of the debtor's property subject to its security. On such an application the onus should be on the applicant to establish that the secured creditor was adequately secured.

A secured creditor should be considered adequately secured if any one of the following is established:

- o the forced sale realizable value of the assets significantly exceeded the debt owing to the secured creditor;

- o the secured creditor had and would be receiving payments on account and there would be no significant deterioration in the value of the assets subject to the security; or

- o assets, such as inventory or accounts receivable, had and would be acquired to replace assets being utilized in carrying on the business and there would be no significant deterioration in the value of the assets subject to the security.

Variation of stay after appointment of a trustee in bankruptcy: If a trustee in bankruptcy is appointed within the 21-day stay period the trustee should have the right to apply for a further 21-day stay of proceedings upon satisfying the court that (1) additional time was required to investigate the affairs of the bankrupt and (2) there appeared to be a reasonable prospect for the rehabilitation of the debtor's business or for its sale as a going concern for an amount in excess of that owing to the secured creditor. If a further extension of the stay period or any broadening of its scope was sought by the trustee, the trustee should once again bear the onus of satisfying the court that the secured creditor was adequately secured.

Problem of Improper Conduct of Secured Creditor or Receiver

Recommendations

The *Bankruptcy Act* should be amended to provide as follows:

1. The bankruptcy court should be empowered to give directions to the secured creditor or receiver similar to those given to the court by Section 63 of the *Personal Property Security Act* of Ontario. This Act provides that the debtor, or any person who is the owner of collateral, or the creditors of either of them, or any person other than the secured party, who has an interest in the collateral may apply to the court for directions that the secured party comply with the obligations imposed by the statute, the collateral be or not be disposed of, or an account to be taken or for such further or other order as the court considers just.

2. A secured creditor and a receiver should be required to give the trustee of a bankrupt estate, or a trustee acting in a proposal, notice of its intention to realize on assets subject to the security, including the proposed method of realization.

3. Statutory duties should be imposed on the secured creditor and receiver:

- o to act honestly and in good faith;
- o to realize on property in a timely and commercially reasonable manner; and
- o to report to the trustee any conservatory measures taken.

Problem of Lack of Information

Recommendations

The *Bankruptcy Act* should be amended to require any receiver appointed by or with leave of the court:

1. to give notice of its appointment to the unsecured creditors within five days after its appointment, as well as other information that may be prescribed by regulation. Such information should include a summary of the most recent financial information of the debtor available to it, the security held by the secured creditor, the amount owing to the secured creditor, the nature of the default, the date of the appointment of the receiver, the length and nature of

the stay imposed on the receiver and any other relevant information available;

2. to deliver semi-annually to the trustee, or to file with the Official Receiver if no trustee is appointed, a report on the administration of the receivership; and

3. to provide a copy of its final accounts to the trustee of the bankrupt estate, or to the Official Receiver if no trustee has been appointed.

Problem of Accounting by Secured Creditor

Recommendations

The *Bankruptcy Act* should be amended as follows:

1. to require the secured creditor or receiver to report to the trustee the results of realization after a sale is completed;

2. to give the trustee of a bankrupt estate the right to require the secured creditor or receiver to have its accounts approved by the court; and

3. if there is no bankruptcy, to give the debtor and any other party, including any creditor, the right to apply to the court for an order requiring the secured creditor or receiver to pass its accounts.

Problem of Conflict of Interest

Recommendations

1. The *Bankruptcy Act* should be amended to include a definition of conflict of interest that would be similar to the following:

..."there is a conflict of interest on the part of any person acting or proposing to act for an estate in any professional capacity whenever such person is required, as a result of his services being retained by the estate;

i) to support or reveal that which his duty to another person requires him to contest or conceal, or

ii) to contest or conceal that which his duty to another person requires him to support or reveal."

2. The *Bankruptcy Act* should be amended by specifically prohibiting a person from acting as trustee, interim receiver or receiver when a conflict of interest exists.

Such a conflict of interest should be deemed to exist where the person is or, at any time during the two preceding years, was

- o a director or an officer of the debtor;
- o an employer or employee of the debtor or of a director or an officer of the debtor;
- o related to the debtor or to any director or officer of the debtor;
- o the auditor, or accountant of the debtor; or
- o related to or the partner of the auditor or accountant of the debtor.

3. No person should be appointed to act as a receiver for a secured creditor where that person is the trustee of the bankrupt estate or is acting as trustee under a proposal by the debtor.

4. No person should be appointed to act as trustee of a bankrupt estate or trustee under a proposal if such person has already been appointed to act as a receiver for a secured creditor claiming a security interest in the property of the debtor.

COMMERCIAL REORGANIZATIONS

Introduction

The cessation of a business and the liquidation of its assets consequent upon insolvency cause both economic and social loss and disruption to those involved. The owners lose their equity; creditors lose all or part of the amount owing to them; employees lose their jobs; suppliers lose a customer and customers lose a source of supply. One of the important functions of insolvency law is to provide a means to avoid, or at least minimize, such loss and disruption whenever there are reasonable prospects of rehabilitating a business in financial difficulty or preserving parts of it as a viable concern.

The reorganization and rehabilitation of an insolvent business require that its essential assets and organization be kept intact and usually that it be kept functioning. That cannot be done if the creditors are at liberty to try and enforce their rights to be paid out of the assets of the business. Hence the need for generally preventing creditors from doing so while the prospects of reorganizing and rehabiliting the business or selling it as a going concern, in whole or in part, are determined.

Current Position

There are three means available in Canada to achieve rehabilitation of a business: a proposal pursuant to Part III of the *Bankruptcy Act*, a receivership, and an arrangement under the Companies' Creditors Arrangement Act (C.C.A.A.).

Proposal

An insolvent debtor may file a proposal, which has the effect of staying proceedings by unsecured creditors. The proposal must be accepted by a special resolution of the unsecured creditors, which requires the affirmative vote of creditors representing 75% in value of the claims and a majority in number of the creditors voting. If the creditors do not approve the proposal, the debtor is automatically declared bankrupt. A proposal that the creditors do accept must also be approved by the court. In almost every case the court accepts the decision of the creditors and does not substitute its own judgment for theirs.

Proposals provide an effective means to reorganize the relationship between a debtor and its unsecured creditors. However, a proposal has no application to secured creditors. Unless secured creditors to whom the essential assets have been pledged are either kept in good standing or agree to cooperate, a proposal cannot be used to effect a reorganization. Such secured creditors have the right to enforce their security notwithstanding the filing of a proposal. As most security agreements contain insolvency clauses, even keeping up payments may not avoid technical default.

Receivership

Receivership also provides a means for the reorganization of the debtor's affairs because it commonly occurs as a result of the enforcement of security that extends to all or substantially all of the debtor's property. Upon default the holder of the security can cause a receiver to be appointed to take possession of and deal with the assets subject to the security. Thus proceedings against such assets by subordinate secured creditors, preferred creditors and unsecured creditors are stayed. Where the receiver is court-appointed, even superior secured creditors may have to obtain leave of the court to enforce their security, although that is only a very short-term protection.

Although receivership is sometimes used in conjunction with a proposal under the *Bankruptcy Act* to effect a reorganization of the debtor, its utility is much more in keeping the viable elements of an insolvent business intact, and often functioning, in order for its sale on a going-concern basis. Although this avoids or ameliorates the losses of liquidation it seldom results in any recovery for unsecured creditors and virtually never provides anything for the owners of the debtor. Even with a going-concern sale the secured creditors commonly end up with a deficiency, although much less than would occur on liquidation.

Companies' Creditors Arrangement Act

The C.C.C.A also offers a means for effecting a reorganization of the affairs of an insolvent debtor. Its provisions can only be used by a debtor that has outstanding bonds or debentures issued under a trust deed, and any compromise or arrangement under that Act must include a compromise or arrangement between the debtor and the holders of the bonds or debentures. Once that condition precedent is satisfied an arrangement under the C.C.C.A. may affect any class of creditors, including secured creditors, and the court has the power to stay proceedings by all creditors, including secured creditors. Proceedings are usually stayed until creditors have had the opportunity to vote on the

proposed arrangement. An arrangement may provide for the separation of creditors into different classes; each class of creditor must approve the proposal. Such approval is obtained by an affirmative vote by a majority in number representing 75% in value of the creditors or class of creditors voting. If the arrangement is approved by the creditors it must be sanctioned by the court and then becomes binding on all creditors included in the classes of creditors subject to the arrangement. There is no automatic bankruptcy if the arrangement is not accepted by the creditors or the court.

Since the C.C.C.A. is only available to debtors who have outstanding bonds or debentures issued under a trust deed, as a practical matter it is only available to businesses of sufficient size to have issued such bonds or debentures: i.e., usually relatively large public companies. Where such companies encounter financial difficulty and the losses that would occur as a result of liquidation are of such magnitude as to make most secured as well as unsecured creditors receptive to a reorganization, the C.C.A.A. has provided an effective means to prevent particular secured creditors from frustrating a reorganization or seeking preferential treatment. However, in the vast majority of insolvencies it is not available.

Background

Objectives

A major objective of most insolvency systems is to facilitate the preservation of a viable business or the viable elements of a business as a going concern and to avoid a liquidation, which disperses the assets and destroys the going-concern values. Yet another major objective must be to avoid unduly affecting the availability, cost and continuation of credit. Since most liquidations are triggered when secured creditors enforce their security, any statutory provision allowing an insolvent debtor time to reorganize its affairs will inevitably restrict the rights of secured creditors.

Previous Canadian Proposals - Bill C-17

The provisions of Bill C-17 dealing with commercial arrangements introduced various changes relating to the reorganization of businesses. The most significant of these changes were as follows:

Stay of proceedings by secured creditors

The filing of a notice of intention to make a proposed arrangement or of a proposed arrangement would have prevented a secured creditor from selling the assets of the insolvent company in bulk out of the ordinary course of business. A secured creditor would be permitted to take possession of property subject to its security, collect accounts receivable and realize on property that was perishable or likely to depreciate rapidly in value.

Secured creditors subject to arrangement

Commercial arrangements would be binding on secured creditors if at least two-thirds of the votes cast by the creditors included in each class of claims were in favour of the arrangement.

Right of other parties to file arrangement

Other parties besides the debtor would have had the right to put forward a commercial arrangement on behalf of the debtor. These parties included the trustee of the bankrupt estate, a receiver and a creditor of the bankrupt.

Repudiation of existing contracts and leases

Under a commercial arrangement the debtor would be given the right to repudiate an uncompleted contract or a lease of real property where the debtor was the lessee.

Court-formulated proposal

In certain limited situations the court would be granted the power to formulate a proposed arrangement acceptable to the creditors and the debtor. This power was to be conferred on the court where the debts (including secured debts) exceeded $1,000,000 and a proposed arrangement was either not accepted by the creditors or not approved by the court. In formulating a proposed arrangement the court was to be directed to have regard to:

- o the interest of any person in the property of the debtor;
- o the possible effect of not having an arrangement on
  - employees and suppliers of the debtor; and
  - the community in which the debtor was located or carried on business; and

- o the feasibility of financing the arrangement and the future viability of the business.

United States Bankruptcy Code - Chapter 11

It has been suggested that Canada adopt provisions for the reorganization of insolvent companies similar to Chapter 11 of the United States Bankruptcy Code. The most significant differences between Chapter 11 and the proposal provisions of Part III of the *Bankruptcy Act* are as follows:

- o The filing of a petition for reorganization by a debtor has the effect of automatically staying proceedings by all creditors, including secured creditors. A creditor desiring the stay lifted must apply for a court order to that effect. The court is required to deal at least preliminarily with such a request within 30 days of its receipt.

- o A plan may be confirmed by the court even though a class of creditors does not accept it. To do so, the court must find that the dissenting class will be treated in a fair and equitable manner. This procedure is generally referred to as a "cramdown."

A summary of the provisions of Chapter 11 is set out in Appendix "A" to this chapter.

The introduction of Chapter 11 reorganization provisions in Canada will reduce the amount of secured credit available to borrowers and will increase borrowing costs. The provisions of Chapter 11 have their greatest impact on the rights of secured creditors. Canadian lending ratios are higher than those in the United States; due to a shortage of risk capital, Canadian businesses have relied on borrowings for their financing. The effect of this higher-ratio lending is that in most Canadian liquidations, there has been no recovery for the unsecured creditors.

A stay of proceedings does not stop a debtor from losing money; in most situations, each day that a business continues the position of the creditors deteriorates. In the United States this risk is usually borne by the unsecured creditors, who are prepared to accept it in order to get an enhanced recovery through a reorganization. In Canada, however, the deterioration resulting from an extended moratorium would usually be borne by the secured creditors. When secured creditors determine that their recovery from debtors' assets will be reduced as a result of an extended moratorium on enforcement proceedings or of an imposed reorganization, they will seek a greater margin of protection and reduce the lending limits for all their more risky borrowers.

The parties standing to benefit the most from a reorganization should be required to bear the financial burden of its failure. In the United States the unsecured creditors bear the burden of any losses caused by a lengthy moratorium or an unsuccessful reorganization and conversely benefit from a successful one. However, in Canada, as a result of our higher lending ratios, the burden of such losses would be borne by the secured creditor while the unsecured creditors and the debtor would still benefit from a successful reorganization. Thus, in Canada a reorganization should not be imposed on a secured creditor against its will.

A most significant problem in the administration of Chapter 11 in the United States has been the delays involved in the process. Although the duration of the debtor's original exclusive right to prepare a plan for reorganization is only 120 days, the court has the power to extend this deadline for months or even years. This has the effect of leaving all parties in a very unstable situation. In addition, the court's assessment of whether a plan should be imposed on a dissenting class of creditors may lengthen the delay while the court hears evidence as to the value of the debtor's assets and determines the respective rights of the parties.

The administrative costs of Chapter 11 proceedings in the United States are proportionally much higher than receivership and proposal costs in Canada. A significant cause of this is the fact that implementing a reorganization requires numerous court hearings, and the legal costs of all parties are usually paid out of the estate.

Available information also indicates that notwithstanding the detailed provisions of Chapter 11, few reorganizations are successful.

Problems

No Stay of Proceedings by Secured Creditors

As the filing of a proposal under the *Bankruptcy Act* does not stay proceedings by secured creditors, they have the power to nullify any attempt at a reorganization. The stay of proceedings by the appointment of a receiver is usually of little benefit to the debtor and its unsecured creditors. The secured creditor and its receiver decide how to conduct a receivership arising from a private appointment. Their likely bias is to seek the largest recovery on the secured loan at the least risk. In the case of a court-appointed receiver, the receiver theoretically does not take instructions from the secured creditor, but as a practical matter the views of the latter tend to prevail.

Although the stay of proceedings available under the C.C.A.A. can be effective, that Act is only available in a small number of situations.

Difficulties of a Stay

Unfortunately, the superficially appealingly simple concept of providing a debtor with a moratorium while prospects of rehabilitation are investigated, has serious problems and consequences, including the following.

- o There is likely to be a cash flow problem. Usually the debtor is losing money daily, and a stay does not stop the losses. There must be money to carry on the business, but suppliers and other creditors usually suspend credit. The cash flow is from inventory and receivables that are subject to claims of existing secured creditors. Normally all the assets of an insolvent debtor are subject to security, frequently comprehensive security such as a debenture, so that there may be nothing available to provide alternate or additional security to whoever has security on the receivables and inventory.

- o The assets may deteriorate in value. In the case of land, plant and equipment the problem may be less acute than in the case of inventory, receivables and good will.

- o A delay on realization deprives creditors of the use of money that would otherwise be available.

No Application of Proposals to Secured Claims

The *Bankruptcy Act* lacks any provision similar to that in the C.C.A.A. whereby the affirmative vote of the requisite majority of secured creditors in the same class binds all secured creditors in that class. Therefore certain businesses cannot be reorganized without the unanimous agreement of all secured creditors. The best example of this is a construction company. Since no form of reorganization can be imposed on mechanics' lien claimants, any reorganization requires the unanimous consent of all the lien claimants. Usually this is impossible to achieve. The ability of one secured creditor to veto a reorganization may be used by that creditor to seek a better recovery than other creditors of the same class.

No Right to Repudiate or Adopt Executory Contracts or Leases

The absence of any provisions in the present *Bankruptcy Act* to permit a debtor who has filed a proposal to repudiate

or amend an executory contract has rendered impossible the reorganization of certain businesses.

Recommendations

Stay of Proceedings

1. An insolvent debtor should have the right to file a Notice of Stay with the Official Receiver. This should have the effect of staying proceedings by unsecured creditors and, if a receiver has not already been appointed, staying the rights of secured creditors or a receiver to sell any property of the debtor out of the ordinary course of business or to remove it from the debtor's premises for 21 days. During this period the secured creditor or receiver should be entitled to exercise the following powers:

- o to take possession of the property of the debtor but not to remove it from the debtor's premises;
- o to collect accounts receivable;
- o to sell property that is perishable or likely to depreciate rapidly in value;
- o to carry on the business of the debtor;
- o to solicit but not accept offers to purchase the assets.

The same stay of proceedings should be applicable when a trustee in bankruptcy is appointed. In each case the purpose of the stay is to give either the debtor or the trustee the right to determine whether a reorganization of the debtor's financial affairs is possible.

2. If no receiver has been appointed when a Notice of Stay is filed, the debtor should be required to appoint a licensed trustee to act as interim receiver with certain powers to be stipulated in the appointment. Such powers unless the court otherwise orders should include the right to review the books and records of the debtor and to account for the disposition of the debtor's property during the interim receivership. Additional powers that might be given to the interim receiver in the appointment or by the court should include

- o making an inventory of the property of the debtor;
- o taking possession of all or part of the property of the debtor;

- o selling all or part of the assets of the debtor;
- o managing the business of the debtor;
- o borrowing money and giving security on the assets of the debtor with the approval of the court.

If any creditor is dissatisfied with the party appointed as interim receiver or the powers granted to the interim receiver, the creditor should have the right to apply to the court for an order substituting another trustee as interim receiver or varying the powers of the interim receiver.

3. During the stay period any secured creditor who had the right to appoint a receiver should be entitled to elect either to do so without obtaining leave of the court or to appoint a monitor instead. Such a monitor should be entitled to inspect and obtain all relevant information relating to the secured assets and the use to which they were being put during the stay.

4. If a proposal is filed by the debtor or the trustee, the stay should be extended for a further period of 21 days to give the creditors the right to vote on the proposal. To avoid any abuse of this provision, the *Bankruptcy Act* should be amended to provide that the meeting of creditors must meet to consider the proposal must be held within 21 days of its filing.

5. The court should have the same powers to shorten or extend the stay period or vary its scope as are set out in the preceding chapter dealing with secured creditors. During the initial stay period and any extension of the stay created by the filing of a proposal, the secured creditor should bear the onus of proving that it was not adequately secured if it sought to have the stay period shortened. If either the debtor or the trustee seek a further extension of the stay period, such party should be required to satisfy the court that the secured party was adequately secured as previously defined.

Application of Proposal to Secured Creditors

It should be possible to file a proposal that includes a compromise between the debtor and all or any classes of its secured and unsecured creditors. Creditors should be entitled to vote on the proposal in their respective classes. The court should have jurisdiction before or after the meetings of creditors to determine any issues relating to the appropriateness of the classes and any other problems that might arise. The division of creditors into classes, especially the allocation of creditors with security on

different assets or with various priorities, must be fair and equitable after considering the nature of the treatment proposed for such creditors.

If at the meetings of creditors any class refuses to approve the proposal by the requisite majority, the proposal in its entirety should be deemed to have been defeated, the stay should cease to apply, the debtor should be deemed bankrupt and the trustee under the proposal should become trustee in bankruptcy. The proposal could provide that the negative vote of a particular class (especially a secured class) did not automatically defeat the entire proposal or did not automatically result in bankruptcy, with safeguards to protect against abuse.

The proposal should be subject to court approval. In other words, the amendments to the *Bankruptcy Act* would introduce the scope and flexibility available under the C.C.A.A. but subject it to some of the procedures and constraints of the present *Bankruptcy Act*.

Court-formulated Proposals

The committee does not recommend the introduction of the concept of court-formulated proposals as set out in Bill C-17 or the "cramdown" provisions of Chapter 11 of the U.S. Bankruptcy Code. The problems they create would outweigh their benefits. There would be a serious risk of reducing the amounts of credit available to borrowers in Canada and increasing the cost of borrowing. The burden of any losses arising from the deterioration in the assets of the debtor should be borne by the parties who would benefit from a successful reorganization. There would be an extended delay in finalizing any insolvency or reorganization. Rather than leaving business decisions to the debtor and the creditors, the court would be granted the power to make such decisions. In many cases the judge hearing the matter may not have a business background and there is a great risk that each judge will approach the problem from a different perspective. Entities that are not economically viable might well be continued for social policy reasons. Administrative costs, including trustees' fees and legal costs, would inevitably escalate, reducing the recovery for creditors.

Executory Contracts

1. The *Bankruptcy Act* should be amended to permit a debtor who either intends to file or has filed a proposal to apply to the court for an order permitting the repudiation or variation of an executory contract. Such a right should only be available to a debtor seeking a reorganization and should not be available to the trustee of a bankrupt estate.

2. The debtor should be required to establish to the satisfaction of the court that

- the contract between the debtor and the third party was onerous;
- the contract was not in the best interests of the debtor and the creditors generally;
- the existing contract rendered reorganization of the affairs of the debtor impractical;
- the proposed amendment to the contract was necessary to the implementation of the reorganization;
- the proposed new contract was fair and equitable;
- the debtor had bargained with the other party in good faith prior to seeking the assistance of the court; and
- the other party rejected the proposed amendment to the contract "without a good cause."

3. If a third party suffers damages as a result of the court's repudiation or variation of its contract, it should be entitled to a claim in the proposal for the purpose of voting and distribution.

4. The court should be given the power to

- vary the terms of the contract; if the contract is varied by the court any affected party should have the right to rescind the contract. If the rescission is by a party other than the debtor, such party should not be entitled to a claim for any damages suffered as a result of the rescission of the contract;
- grant relief against forfeiture; and
- cancel the contract altogether on such conditions as the court may deem fit for the purpose of protecting the interests of the creditors generally and having regard to the debtor's plan of reorganization.

Comment

Any loss suffered by the third party whose contract has been varied is outweighed by the benefits to the community at large, such as preserving the business entity, continuing employment, continuing productivity and maximizing the recovery for all creditors generally.

Acceptance of Proposal by Creditors

The value of the claims of creditors required to accept a proposal should be reduced from 75% to 66 2/3%. The agreement of a majority of the creditors voting should still be required. This amendment should facilitate the acceptance of proposals by creditors and reduce the power of a minority of the creditors.

APPENDIX A

A Summary of the Provisions of Chapter 11 of the United States Bankruptcy Code

The new United States Bankruptcy Code became effective in October 1979 and underwent significant revisions in 1982. Chapter 11 of that Code deals with business reorganization. Before 1978 four different chapters of the U.S. *Bankruptcy Act* dealt with reorganizations. Whether the 1982 revisions have solved the problems being encountered with the new Chapter 11 has yet to be determined. The chief provisions of Chapter 11 are as follows:

(1) An entity seeking a reorganization files with the court a petition alleging that it is a debtor qualified to seek reorganization under Chapter 11. The Code does not require the debtor to be insolvent or unable to pay its debts as they become due and there is no minimum indebtedness required.

(2) The filing of the petition constitutes an "order for relief" which triggers the automatic stay provisions of the Code. The automatic stay operates as a broad stay on proceedings by all creditors, including secured creditors. Any creditor affected by the stay has the right to apply to the court for relief from the stay. The court must, at least preliminarily, hear and rule upon the request for relief within 30 days after the filing of the petition; otherwise the stay is automatically lifted. Grounds for lifting the stay against a secured creditor are "cause," including lack of adequate protection for the interests of a secured party, the debtor's lack of equity in property or the unimportance of property for the reorganization.

(3) The debtor remains in possession of its property unless a trustee is appointed by the court. The "debtor in possession" in a sense acts as the debtor's trustee. The debtor's assets become an "estate" and the debtor in possession has virtually all the powers and duties of a trustee in a reorganization. These include requiring the turnover of property of the estate that is in the hands of third parties, setting aside prepetition transfers such as preferential payments or fraudulent conveyances, and avoiding the statutory liens that may arise by virtue of the insolvency of the debtor, such as liens for rent or distress for rent.

(4) The debtor in possession is entitled to carry on the debtor's ordinary business without an order of the court, using and selling property that may be subject to the claims of secured creditors, such as inventory and accounts

receivable. However, the debtor in possession is not entitled to use the proceeds of the inventory and accounts receivable or other secured assets once they become cash or its equivalent, "cash collateral," and must obtain an order to permit the use thereof. A secured creditor has the right to request that the debtor in possession give adequate security for any interest in property, including the proceeds of inventory and accounts receivable, that the debtor proposes to use, sell or lease.

(5) The debtor in possession has the power to obtain credit and incur debt. If the debtor in possession is unable to obtain unsecured credit or unsecured debt with priority equal to other administrative expenses, the court has the right after notice and hearing to authorize the debtor in possession to obtain credit or incur debt having priority over an existing lien if the existing lien holder is "adequately protected."

(6) If the court approves, the debtor in possession is entitled to assume or reject executory contracts or unexpired leases of the debtor.

(7) As soon as practicable after the filing of the petition, the court must appoint a creditors' committee, which will generally consist of the seven largest creditors. This committee plays a very powerful role in a reorganization. With the court's approval the committee can hire accountants, lawyers or other agents to perform services for the committee, all at the expense of the estate.

(8) The debtor in possession is given the exclusive right during the first 120 days to prepare a plan for reorganization. The court has the power to extend this deadline and frequently grants extensions, which may go on for months or even years.

(9) A plan of reorganization must specify whether the rights of any class of claims or interests are "impaired" under the plan and what treatment is proposed for such a class. It is possible for some classes of creditors to have their rights impaired while others are unaffected.

(10) Each class of creditors must accept the plan or be deemed to be treated "fairly" and "equitably" under the plan. A class of claims accepts a plan if, of those voting, two-thirds in dollar amount and more than one-half in number approve the plan. A class that receives nothing under the plan is deemed to have rejected it. A class that is not impaired is treated as having accepted the plan. Even if a class rejects a plan, it can still be confirmed if at least

one impaired class accepts it and the dissenting class is given "fair" and equitable" treatment. This is what is generally referred to as the "cramdown" provision of the code.

(11) There are two situations in which a plan is considered fair and equitable to a class of impaired unsecured claims and therefore the class acceptance of the plan is not necessary. One case occurs if the class receives under the plan property with a present value equal to the full amount of the "allowed" claims of the class; in the other case, the class receives under the plan whatever reorganization values are available after satisfaction of senior classes and no junior interest receives any reorganization values.

A plan is considered fair and equitable to a class of secured creditors, usually only one creditor, if it provides that:

- o the creditor retains the lien securing its claim to the extent of the allowed amount of the secured claim and receives deferred cash payments totalling such amount but having a present value as of the effective date of the plan of at least the value of the collateral;
- o the creditor will receive the "indubitable equivalent" of its allowed secured claim; or
- o the collateral will not be sold free and clear of the creditor's lien unless the creditor is afforded an opportunity to bid in its claim, the lien will attach to the proceeds from the sale and the lien on the proceeds will be treated under one of the other two prescribed methods.

Even if a class accepts a plan, dissenting class members are said to be protected under the Code because it provides that dissenting members must receive at least what they would receive on liquidation. The effect of this requirement is that as long as senior accepting classes, even though not fully compensated, receive liquidation value, junior classes may receive reorganization values without disrupting the reorganization. In other words, secured creditors are deemed to be entitled only to liquidation values of the secured assets, not going-concern values.

Chapter 11 appears to assume that secured creditors have no effective means to capture, and no effective or enforceable right to, going-concern values. Their "allowed" claims are basically limited to liquidation values.

SUPPLIERS OF MERCHANDISE

Current Law

There are no provisions in the present *Bankruptcy Act* giving special rights to sellers of merchandise to the bankrupt. Subsection 178(6) of the *Bank Act* gives a producer of agricultural products priority over a bank in respect of a specified portion of a claim the producer might have for a product delivered to a manufacturer during the six months preceding the manufacturer's bankruptcy. At the provincial level, the provisions of the Quebec Civil Code permit an unpaid vendor to repossess products delivered to an insolvent buyer. In the common law provinces vendors may register security interests over products delivered to buyers under personal property security legislation. The taking of such security makes the supplier a secured creditor.

Background

The underlying philosophy of any bankruptcy legislation should be equal treatment of all creditors. A strict application of this philosophy would entail a system free of priorities in which each creditor would be entitled to receive a share of the assets of the debtor on a pro rata basis. However, given the existing economic structure, such an approach is unrealistic as it would lead to many restrictions in commercial practice. For example, financial institutions not permitted to take security would demand guarantees so onerous that debtors' access to credit would be reduced. Thus if it is conceded that any amendments are not intended to change the foundation of the existing economy, only changes should be proposed that will permit the fair treatment of all intermediaries while allowing the smooth operation of commerce.

Acceptance of this premise necessitates the existence of security interests. Some creditors, such as financial institutions, have sufficient leverage to require debtors to give them priority. However, some groups do not have the strength to negotiate terms that would guarantee them prior treatment in the event of a bankruptcy. It is widely accepted that workers should receive special treatment under bankruptcy legislation because they are not in a position to negotiate such treatment. The issue before the committee was whether unpaid suppliers of merchandise to insolvent buyers should receive protection under the *Bankruptcy Act* over and above that provided to creditors in general. If so, what should be the extent of that protection and should it include priority over secured creditors?

In Canada, only the Province of Quebec has adopted legislation affording suppliers of merchandise any preferred rights. In all other provinces the rights of creditors have been determined by contractual provisions negotiated between the parties. Some provinces have established a system whereby suppliers of merchandise may give notices entitling them to priority over secured creditors. However, the system is not effective in many cases because the giving of such notices may constitute default under security agreements or is prohibited by such agreements.

Problems

A majority of the committee members, representing the common law provinces, were of the opinion that the existing legislation does not require any reform. Their view was that unpaid suppliers should be treated equally with other classes of unsecured creditors. Any special treatment of unpaid suppliers would deprive other unsecured creditors of assets that would otherwise be available for distribution to them. In addition, it would be inequitable and without justification to distinguish between suppliers who have delivered merchandise within a specified period prior to the insolvency and other suppliers who delivered goods before that period. A minority of the committee members, representing the Province of Quebec, was of the view that, within the existing economic structure, suppliers are not in a position to negotiate with their debtors such terms as would reestablish the appropriate balance of power, given the relevant importance of such suppliers to the survival of their debtors. This fact highlights, in the opinion of the minority group, the need for legislative intervention to guarantee suppliers of merchandise rights commensurate with their importance to the financial health of debtor enterprises.

Many problems have been encountered in the Province of Quebec with respect to the application of legislative provisions dealing with the protection of suppliers and merchandise. The most serious problems involve the identification of merchandise and the procedure for the revendication of goods. These problems have caused significant confusion and have greatly increased the expense involved in administering the assets of an insolvent debtor.

Solutions

There are three options:

- the status quo could be maintained, leaving the onus on the provinces to legislate some form of protection for suppliers of merchandise;

- an amendment to the *Bankruptcy Act* could be introduced to provide suppliers of merchandise with the tools that would enable them to protect themselves against at least part of the losses resulting from the insolvency of their debtors; or

- the *Bankruptcy Act* could be amended to include a provision enabling provinces that have enacted the right of revendication to benefit from certain amendments to be inserted in the *Bankruptcy Act*.

Comment

In the event that either the second or third of the above options should be implemented, the amendment should provide for the following:

- unpaid vendors should be granted the right to be reimbursed for goods delivered within five working days prior to the bankruptcy or receivership on the basis of invoice price and proof of delivery;

- the request for reimbursement must be made within 21 days of the receivership or bankruptcy;

- this right should constitute a priority ranking after the payment of the administration costs and unpaid wages and prior to any payment to a secured creditor;

- this right should be suspended in the event of a reorganization pending the decision on a proposal. If a proposal were accepted by the creditors and approved by the court, the special priority of the unpaid vendor would be abolished.

Recommendation

There should be no change to the *Bankruptcy Act* with regard to the rights of unpaid vendors. Granting special treatment to unpaid vendors would be inequitable and prejudicial to the position of other unsecured creditors. Each province should retain the right, if it deems fit, to grant or maintain secured creditor status to an unpaid vendor. Such treatment would be recognized in the administration of the *Bankruptcy Act* just as the claims of other secured creditors are recognized.

CONSUMER BANKRUPTCIES AND ARRANGEMENTS

Special Provisions for Consumers

Current Law

At the present time there are two types of administration applicable to the estates of individual bankrupts, summary administration and ordinary administration. Summary administration applies if it is anticipated that the assets available for distribution to the unsecured creditors will not exceed $500. All other estates are ordinary administration. In summary administration the procedures are somewhat streamlined, chiefly by eliminating advertising and the necessity for inspectors.

The existing Act makes provision for consumer insolvents only in Part X, which deals with orderly payment of debts. This part only applies in the six provinces that have adopted it and only contemplates situations where the full amount of the debts is to be paid. It is of no use in situations where the consumer debtor is unable to pay the full amount of the debt and excludes consumer debtors in much of Canada, including Ontario and Quebec. These provinces have alternative programs and legislation dealing with the same objectives. Quebec has the Lacombe Law and Ontario has provisions for consolidation orders under the Small Claims Courts Act as well as a debtor counselling program administered by the Ministry of Community and Social Services.

A creditor unable to make use of the Part X provisions must resort to the generally applicable proposal provisions of the Act, which were drafted with the needs of commercial debtors in mind. In some localities, consumers have been able to make proposals under the present Act because trustees have economically prepared simple documents from a precedent in a minimum amount of time. In such cases the costs of administration are usually deferred and taken as a percentage of dividends when distributed. Regular payments are made to the trustee and funds distributed on a periodic basis to the creditors. In other localities much more elaborate procedures are followed in the belief that there must be a complete and thorough adherence to the provisions of the *Bankruptcy Act*. In such cases the costs of a proposal are much higher and it is not economically feasible for consumers to utilize the proposal provisions of the present *Bankruptcy Act*.

Consumer proposals do not comprise a large percentage of insolvency procedures because the vast majority of consumer debtors are unemployed or belong to the lowest socio-economic levels. Brighton and Connidis, in their paper *Consumer Bankruptcy in Canada*, published in 1982, report that consumer bankruptcy is largely a working-class phenomenon associated with the unskilled and semi-skilled but that middle-class persons are not immune. Proposals or arrangements for consumers are only practical for the middle class, or in other words for a statistically small group. Proposals under the present Act are further greatly restricted and frequently rendered impossible by Crown preferences, principally for income tax arrears.

To be binding on all creditors, a proposal under the present *Bankruptcy Act* must be accepted by a special resolution of the creditors passed by a majority of the creditors in number and 75% in dollar value and approved by the court.

Administration of Consumer Bankruptcies

Problem

Since the determination as to which type of administration applies is based solely on assets, the bankrupt with a substantial amount of debt or a very high earning ability is entitled to utilize the summary administration procedure. This may result in a less intensive scrutiny of the debtor's affairs and gives the public the perception that bankruptcy is too easy.

Options

There are three potential solutions:

- maintain the status quo by using the asset test to categorize the type of bankruptcy administration;
- determine the type of administration by the extent of the liabilities of the debtor; or
- combine the first two options by stipulating maximum limits for assets and liabilities.

Recommendation

The type of administration applicable to the bankruptcy of an individual should be determined by the extent of the bankrupt's liabilities. The more thorough and extensive form of administration should apply to situations where there are greater liabilities. The fact that the bankrupt does not appear to have any assets available for distribu-

tion to its unsecured creditors should not be the governing factor. It is too easy for a debtor to dispose of assets in order to avoid a thorough investigation of its affairs. A consumer debtor should not include someone whose preferred and unsecured debts exceed $40,000 or such other amount as may be prescribed by regulation. This approach gives flexibility in the event of future inflation.

Consumer Proposals

Problems

The present law does not provide an expeditious and inexpensive procedure for an individual with relatively few debts to avoid bankruptcy by making a proposal to the creditors to settle the debts by paying less than their full amount. Also, under the present Act there is an automatic bankruptcy when a proposal is rejected by the creditors. This has deterred some consumer debtors from filing proposals.

Recommendations

Proposals by consumer debtors

The *Bankruptcy Act* should be amended to permit the filing of proposals by consumer debtors. These proposals should be administered by a licensed trustee since the relatively low expected number of consumer proposals does not justify the establishment of a costly bureaucracy.

Procedural changes

1. A creditor should only be required to file a proof of claim if the amount of the debt shown on the list of creditors provided by the trustee is incorrect.

2. Creditors should vote by written ballot unless creditors representing 25% in dollar value of the debts request a meeting of creditors. All creditors should be given notice of that meeting but should also be permitted to vote by voting letter at that meeting.

3. It should only be necessary to apply for court approval of a proposal if a creditor requests a review of the proposal by the court.

4. The trustee should file a certificate of compliance with the Official Receiver when a consumer debtor has fulfilled all its obligations under the proposal.

5. The rejection of a proposal made by a consumer debtor should not automatically result in a bankruptcy.

Deficiency claims

A consumer proposal should not bar deficiency claims by secured creditors when they have realized on their security, because such a provision may cause a restriction of credit to the lower socioeconomic strata of our society. This would penalize the vast majority of that class of people who do not abuse credit and who rely on it to help achieve an accumulation of goods over their lifetime.

Assets Vesting in Trustee

Current Law

Under the present *Bankruptcy Act*, assets that are exempt from execution or seizure under the laws of the province within which the property is situate and within which the bankrupt resides do not vest in the trustee for distribution among the creditors. Most provinces do not provide for an exemption for funds deposited in a registered retirement savings plan although life insurance policies and pension benefits are usually exempt.

Problem

The self-employed person who has diligently provided for retirement and subsequently suffers a misfortune should not be stripped of this means of support in retirement.

Recommendation

The *Bankruptcy Act* should be amended to include a provision that the amount to the credit of a bankrupt in a registered retirement savings plan up to an amount prescribed by regulation should not be divisible among the creditors. The maximum amount of such exemption at the present time should be $50,000.

Payments From Income of Bankrupt

Current Law

Under Section 48 of the present Act the court is given the power to direct an undischarged bankrupt who is an employee to pay to the trustee such part of his or her salary or other remuneration as the court may determine, having regard to the family responsibilities and personal situation of the bankrupt. Also, when the bankrupt applies

for a discharge, the court has the power to make the discharge conditional upon the bankrupt making payments to the trustee for distribution among the creditors.

Problems

Self-employed Bankrupts

The court has held that the provisions of Section 48 of the *Bankruptcy Act* do not apply to a self-employed person such as a professional. Accordingly, an undischarged professional person earning a large income cannot be required to make any payments to creditors.

Orders for Payment

Many applications for discharge made by bankrupts are dealt with in a routine and perfunctory manner. Bankrupts with significant earning potential are thus granted discharges without any orders requiring payments to be made to the trustee for distribution among the creditors. This results in the public perception that there has been an abuse of the bankruptcy process.

Recommendations

Self-employed Bankrupts

Section 48 of the *Bankruptcy Act* should be amended to permit the court to direct a self-employed undischarged bankrupt to forward a portion of earnings to the trustee for distribution among the creditors. In considering the amount of such payment the court should take into account normal business and operating expenses.

Orders for Payment

If a bankrupt has net earnings in excess of $40,000 after deducting all business expenses, the trustee should be required to apply to the court for an order making the discharge of the bankrupt conditional upon the bankrupt paying a portion of income to the trustee for distribution among the creditors. The onus should be placed on the bankrupt to satisfy the court why such an order should not be made.

Discharge of Bankrupt

Current Law

Section 139(1) of the Act provides that the making of a receiving order against, or an assignment in bankruptcy by, a person operates as an application for discharge unless the bankrupt serves a waiver of such application. The trustee is required to obtain a date from the court for the hearing of the discharge and to give notice of such date to all creditors who have proven their claims. The trustee is also required to prepare and file with the court a report on the conduct and affairs of the bankrupt. A creditor who intends to oppose the discharge on grounds other than those mentioned in the trustee's report must file a notice of opposition specifying such grounds. In many instances, if there is no notice of opposition, the court will grant the discharge without requiring either the bankrupt or the trustee to be present at the hearing. If a notice of opposition is filed, the bankruptcy court judge must hear the application for discharge, but this occurs in a very small number of cases.

Problem

In a large majority of cases the proceedings relating to the bankrupt's discharge are routine and cause additional unnecessary expense.

Recommendation

A consumer bankrupt should be discharged automatically nine months after the date of bankruptcy unless either:

- a creditor files a notice of opposition to the bankrupt's discharge; or
- the bankrupt has net earnings in excess of $40,000.

If the hearing of the discharge is required, it should be held before the bankruptcy court judge and the trustee should be required to prepare a report on the affairs and conduct of the bankrupt.

Release of Debts

Current Law

One purpose of the *Bankruptcy Act* is to provide an insolvent person with relief from the burden of debt. Under Section 148 of the Act, a discharged bankrupt is not released from the following debts:

- any fine or penalty imposed by a court or any debt arising out of a recognizance or bail bond;
- any debt or liability for alimony;
- any debt or liability under a maintenance or affiliation order or under an agreement for maintenance and support of a spouse or child living apart from the bankrupt;
- any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity;
- any debt or liability for obtaining property by false pretenses or fraudulent misrepresentation;
- liability for the dividend that a creditor would have been entitled to receive on any provable claim not disclosed to the trustee, unless such creditor had notice or knowledge of the bankruptcy and failed to take reasonable action to prove the claim; or
- any debt or liability for goods supplied as necessaries of life.

Problems

The object of the *Bankruptcy Act* should be to release the insolvent debtor from as many liabilities as possible. The purpose of not releasing debts for necessaries was to ensure that individuals would be able to purchase necessaries on credit without their creditors being concerned that such debts would be discharged if a bankruptcy occurred. Given the current extensive use of credit and competition among credit-granting institutions, there is no longer a need to preserve such debts. Individuals will be able to obtain credit for the purchase of necessaries whether or not such debts are released by bankruptcy.

Many bankrupts are harassed by lending institutions alleging that their debts are not discharged by bankruptcy on the basis that they have been obtained by fraud. As a result, discharged bankrupts are coerced into making payments on debts that are legally discharged.

Recommendations

Section 148 of the *Bankruptcy Act* should be amended

- to delete the reference to any debt or liability for goods supplied as necessaries of life; and
- to provide that a debt or liability arising out of fraud is not released where the debtor has been convicted of fraud under the Criminal Code.

The latter recommendation protects the creditor who has actually been defrauded but permits the bankrupt to obtain a release of a debt where the circumstances do not justify a criminal conviction.

Rights of Spouse of Bankrupt

Background

The common law view was that after a marriage, the husband was the only person entitled to hold property. Various provinces enacted statutes making it possible for wives to hold property separate from their husbands; notwithstanding this, the husband in a majority of cases continued to hold title to such assets as real property and bank accounts in his name alone. This ownership frequently gives rise to problems when there is a marriage breakdown.

Until the decision of the Supreme Court of Canada in *Rathwell v. Rathwell* [1978] 2 S.C.R. 436, none of the provincial legislatures had given guidance to the courts for the resolution of matrimonial property disputes. Although all the assets were in the husband's name, the court adopted the constructive trust theory and held that the husband held the property in trust for himself and his wife. The court directed a division of the property between the spouses.

Since that case the legislatures of all the provinces and territories except Quebec and the Northwest Territories have passed legislation dealing with matrimonial property. They have given the court the power to order a division and distribution between the spouses of what has become referred

to in the legislation as "matrimonial" or "family" property or assets. Generally speaking, in the absence of an agreement between the spouses dividing assets between them, this legislation has the effect of enabling the appropriate court upon the breakdown of a marriage to direct division of matrimonial or family property between the spouses.

Problems

Current legislation has not addressed the question of distribution of matrimonial or family property pursuant to settlement agreements entered into by the spouses or orders made by a court in circumstances where either or both spouses were insolvent when the agreement was entered into or the order was made or where the effect of implementing the terms of the agreement or order would be to render one spouse insolvent.

Under the present state of authorities any matrimonial or property settlement agreement or order could be attacked by or on behalf of creditors of the insolvent spouse under the existing settlement or reviewable transaction sections of the *Bankruptcy Act* or pursuant to provincial fraudulent preference or fraudulent conveyance legislation.

Recommendation

The committee recommends that a task force be created to develop recommendations for proposed legislation to amend the current *Bankruptcy Act* relative to the respective rights of the creditors of the bankrupt and the spouse of the bankrupt. The goal should be to settle such respective rights of the parties on a fair and equitable basis. There has been no significant public discussion of this problem.

PREFERRED CLAIMS

Crown Priority

Current Law

Section 107 of the *Bankruptcy Act* provides that, subject to the rights of secured creditors, the proceeds realized from the property of the bankrupt shall be applied in priority of payment as follows:

- o funeral expenses;
- o administration costs;
- o Superintendent of Bankruptcy's levy;
- o wages;
- o municipal taxes that are not a lien on land;
- o landlord;
- o legal costs of first seizing creditor;
- o workmen's compensation, unemployment insurance and deductions owing under the *Income Tax Act;*
- o injuries to employees not covered by any workmen's compensation acts;
- o claims of Crown, provincial or federal, not previously mentioned.

Since the statutory priority under Section 107 ranks behind secured claims, the federal government and most provincial governments have created statutory deemed trusts or deemed liens which were intended to rank in priority to the claims of secured creditors. The federal government has done this in respect of claims for amounts deducted from employees under the *Canada Pension Plan Act*, the *Unemployment Insurance Act* and, in the most recent budget, the *Income Tax Act*. Provinces have created statutory deemed trusts and liens to cover amounts owing for wages and vacation pay. The attempt of the Province of Quebec to create a statutory lien for retail sales tax was rejected by the Supreme Court of Canada in the case of *Deputy Minister of Revenue* v. *Rainville (in re Bourgault)* [1980] 1 S.C.R. 35. Similarly, the Supreme Court of Canada in the recent case of *Deloitte, Haskins & Sells Limited v. Workers'*

Compensation Board [1985] 55 C.B.R. (N.S.) 241 ruled that the Workers' Compensation Board of Alberta was not entitled to a secured claim in a bankruptcy on the grounds that Section 107(1)(h) of the *Bankruptcy Act* conflicted with the provisions of the *Workers' Compensation Act*, creating a secured claim that rendered the provisions of the latter Act inoperative after a bankruptcy has occurred. This was the most recent of a long series of cases dealing with the validity and priority of statutory deemed trusts and liens. In some instances there are conflicting decisions in different provinces. There is no doubt that while provincial legislation can validly secure debts on the property of the debtor in a non-bankruptcy situation, once bankruptcy occurs Section 107(1) of the *Bankruptcy Act* determines the status and priority of the claims specifically dealt with in that section.

Section 47 of the *Bankruptcy Act*, which excludes from a bankruptcy all property held by the bankrupt in trust for any other person, has also been used to circumvent the provisions of Section 107(1). This is done for the obvious reason that since the property does not belong to the bankrupt, the creditors should have no right to share in it. Both federal and provincial legislation have resorted to a legal fiction to recover certain debts in priority to the claims of secured creditors. They have created the deemed trust where the law grants to the government or the beneficiary of the deemed trust a claim against all the assets of the bankrupt ranking in priority to the claims of secured creditors. This fiction applies even though amounts deducted, which were supposed to have been kept separate and apart, were in fact not so kept. In some cases, a deemed trust is created even where there is no obligation to make a deduction from the wages of the employee, such as the claim for vacation pay under the *Employment Standards Act* of Ontario.

The same priorities apply to proposals under Section 41(4) of the *Bankruptcy Act*. A proposal cannot be approved by the court if it does not provide for the same priority of payment of claims as Section 107 of the *Bankruptcy Act*.

Problems

The proliferation of statutory deemed trusts and liens has created significant uncertainty and confusion in the distribution of a bankrupt's property. The priority attributed to Crown claims, either by way of statutory deemed trusts and liens or under Section 107 of the *Bankruptcy Act*, has reduced the ability of a debtor to make a proposal to its creditors. Frequently, the requirement that claims

of the Crown be paid in full before there is any distribution to the unsecured creditors prevents an effective reorganization.

Unsecured creditors often do not take an active interest in the administration of a bankruptcy because all the proceeds of any recovery will go the the Crown as a preferred creditor. The Crown, either federal or provincial, seldom involves itself in the administration of a bankrupt estate. In many instances, a representative of the Crown will not attend the first meeting of creditors or will not act as an inspector. It is also most unusual for the Crown to advance any money to recover assets for a bankrupt estate. Crown corporations also have the advantage of the same priority, and this creates unfair competition against private sector companies in the marketplace.

Options

Option A - Crown Priority

1. Crown priority would be totally abolished, under both federal and provincial jurisdiction, and all claims of the Crown would rank in the same priority as those of unsecured creditors. The elimination of the Crown priority would include all provincial and federal legislation purporting to give a priority, whether by way of security, statutory trust or lien or otherwise for any debt not contractually incurred. The abolishment of priority would include all Crown corporations, either federal or provincial.

2. Any future Act of Parliament must make a direct reference to the *Bankruptcy Act* in order to supersede the provisions of the *Bankruptcy Act* dealing with the priority of distribution of a bankrupt's property.

Option B - Crown Priority

1. Under the American Bankruptcy Code, the federal government retains a priority for deductions at source and other amounts owing. However, in the event of a reorganization under Chapter 11, the United States government does not have the right to vote and must accept automatically a six-month payout with interest at the market rate. This priority has not created any particular problem, any lack of interest by creditors or any lack of the possibility of reorganization for the following reasons:

- the amount to be paid is spread out over a period of six months;

- o in the United States, the law does not permit a creditor to take a blanket security such as the floating charge that exists in Canada. Thus, there always appear to be free assets with which to pay the government priority and to fund the costs of the reorganization of the debtor, including the creditors' committee.

2. The priority of the Crown, whether by way of secured claim, statutory trust or under Section 107 of the *Bankruptcy Act*, for amounts deducted from the wages of employees would be limited to those amounts deducted from employees' wages during the 90 days prior to the date of bankruptcy. The priority would not apply to the employer's contributions. No other debts due to the Crown, either federal or provincial, would have the right of priority; they would be treated as all other unsecured creditors.

3. In the event that the unsecured and secured creditors accept a proposal for a reorganization, the Crown, either federal or provincial, would be required to automatically accept a 12-month payout of its prior priority claim with interest at the market rate. Interest at market rate would mean the interest charged by the Bank of Canada as the "rediscount rate."

Recommendation

The committee recommends the abolishment of the priority of the Crown in accordance with Option A. The burden of tax left unpaid by the bankrupt should be divided among all the tax-paying public rather than borne by the creditors, who have already suffered losses. Such abolishment should also improve the administration of bankrupt estates since in many instances the Crown does not get involved in such matters, even when it appears to be the only creditor entitled to a dividend. The abolishment of Crown priority should give the unsecured creditors a greater incentive to involve themselves in the administration of bankrupt estates.

Other Preferred Claims

Background

The *Bankruptcy Act* attempts to treat all creditors on an equal basis. When the original Act was passed, the legislators determined that certain groups of creditors required additional protection. The question at issue today is whether these groups still need such assistance.

Recommendations

Funeral Expenses

Section 107(1)(a) of the *Bankruptcy Act* provides that in the case of a deceased bankrupt, the reasonable funeral and testamentary expenses incurred by the individual's legal personal representatives take first priority after secured creditors. This protection should be retained, since every person is entitled to a decent burial. However, to avoid the uncertainty of what constitutes "reasonable expenses" and unnecessary legal actions, the funeral expenses should not exceed in any case $5,000.

Administration Costs

Section 107(1)(b) of the *Bankruptcy Act* should retain its current wording. Such expenses and fees of the trustee include occupation rent to the lessor and legal costs. In any event, to permit an effective administration of the affairs of the bankrupt, the administration costs should rank in priority to all Crown claims, including statutory deemed trusts and liens.

Superintendent's Levy

The levy payable under Section 107(1)(c) should be retained since it covers the government's expenses for the administration of bankruptcy matters.

Wages and Salaries

This matter has been dealt with specifically in the first section of this chapter.

Landlord

In the past, the landlord, being an owner of an immovable property, was deemed an important cog in the economic world who had to be protected to a greater extent than the suppliers of goods and services and other creditors. However, in 1985, such additional protection is unwarranted, although provincial law does give such a priority. A landlord's claim should be treated equally with the claims of other unsecured creditors and the landlord's privilege should be abolished. The estate should still be responsible for payment of occupation rent as an administrative expense.

Legal Bill of Costs of First Seizing Creditors

The legal bill of costs of the first seizing creditor should not be given priority. All creditors should be treated equally. There is no reason why a creditor who makes the first seizure should be paid its costs in priority to the costs or claims of other creditors.

FARMERS AND FISHERMEN

Current Law

Farmer's Creditors Arrangement Act

Under the 1934 *Farmer's Creditors Arrangement Act*, if a farmer made a proposal that was rejected by the creditors, the court was entitled to formulate an arrangement. If necessary, the court was empowered to reduce a secured creditor's debt. The 1934 Act applied to farmers in all provinces. In 1943 the Act was amended and applied only to Alberta, Manitoba and Saskatchewan. The Act of 1943 has no practical effect since it only applies to debts contracted prior to December 15, 1943. There have been no proceedings under this Act since 1959. In response to the increase in the number of farm bankruptcies and high interest rates, Bill C-653 was introduced. This Bill, which is essentially the Farmer's Creditors Arrangement Act of 1943 with the territorial and time limitations removed, was given second reading on March 13, 1983. It has not been enacted.

Current Bankruptcy Act

The *Bankruptcy Act* contains a special provision under which an individual engaged solely in farming or fishing cannot be forced into bankruptcy by a creditor filing a bankruptcy petition. However, if a farmer files a proposal that is not accepted by the creditors, the farmer is in the same position as any other debtor and is deemed to be bankrupt. There are no provisions to prevent secured creditors from exercising their security interests against farmers or any other debtors. There are also no provisions giving farmers a special priority in situations where their customers are insolvent.

Section 178(6) of the *Bank Act*

Section 178(6) of the *Bank Act* gives priority over the claims of a bank to a farmer's claim for amounts owed by purchasers of perishable agricultural products that have been delivered. This protection is limited. Priority is valid only if the bank takes possession after bankruptcy occurs; the section provides priority over banks only; the priority applies only up to a specified amount; and banks can circumvent the section by relying upon security interests under provincial legislation.

Background

The comments and recommendations contained in this paper relate primarily to farmers. However, in keeping with a well-established tradition, all special provisions and recommendations should also apply to fishermen.

During the highly inflationary 1970s many farmers expanded their operations by using a significant amount of debt financing to invest in farmland, capital improvements and equipment. Today, faced with declining land prices, reduced product selling prices, increasing input costs and a heavy debt load, many of these farmers are experiencing severe financial problems and will not be able to continue their farming operations unless they can restructure their existing debt load. As a result of the recent economic recession in Canada the number of farm bankruptcies has increased dramatically.

Farmers are also faced with special problems as suppliers, in that they generally have difficulty in obtaining security from their customers upon delivery of their goods due to the perishable nature of their produce.

Since farmers are vulnerable in many ways, questions have been raised as to whether there should be special provisions in the *Bankruptcy Act* to assist farmers who are insolvent or who sell to customers that are insolvent. The two main issues may be summarized as follows.

- Where farmers are debtors, should the court be entitled to formulate arrangements between farmers and their creditors when an agreement between both parties cannot be reached?

- Where farmers are creditors, should they benefit from special priority when their customers are faced with formal insolvency proceedings?

Solutions - Farmers in Financial Difficulties

Four alternatives have been considered to assist farmers who are experiencing financial difficulties.

Option A - Provide for court-formulated arrangements

The court would be given the power to formulate arrangements for farmers when an agreement cannot be reached between farmers and their creditors. The courts, in formulating such an arrangement, would take into account economic

and social factors such as the feasibility of financing the arrangement and the effect on the debtor's employees and suppliers and on the community in which the debtor is located or does business if an arrangement could not be made. To assist the court in formulating an arrangement, it should be entitled to appoint a panel of experts consisting of a trustee, resident farming experts and a representative from a lending institution. If the court-formulated arrangement was rejected by the farmer's creditors, the court could still approve the proposed arrangement as formulated, amend the arrangement without the concurrence of either the creditors or the debtor or withdraw it. During the period of time in which the court was formulating an arrangement, there should be an automatic stay of proceedings by all creditors, including secured creditors.

This solution would provide farmers with an additional method of avoiding bankruptcy. There are numerous problems in choosing this option.

- There would probably be a shift in lending by financial institutions away from farmers toward less risky industries where such provisions are not available.

- The court's intervention in contractual commitments would probably be perceived by creditors as undesirable and possibly inequitable.

- Special protection to one section of the economy would generate controversy.

- It would be difficult for a farmer to obtain credit for carrying on future operations if certain classes of creditors strenuously opposed the arrangement on the basis of poor management or lack of viability.

- A court might make amendments to the arrangement that would not be acceptable to the debtor, making it impossible for an ongoing operation to succeed.

- Pressure might be placed on the court to support non-viable enterprises for social rather than economic reasons.

Option B - Provide for farmers to proceed in accordance with the provisions set out herein re commercial reorganization

Under this solution, the farmer is provided with a stay period of at least 21 days in order to formulate a proposal. However, if the proposal is not accepted by the creditors, the farmer would automatically be bankrupt. Farmers would not be given any special treatment beyond that provided for other commercial debtors. Those farmers whose operations were not economically viable would probably not succeed in their proposals. A drawback with this option is that, given the automatic bankruptcy provision, farmers may be hesitant to try to reorganize their debts by filing a formal proposal.

Option C - Set out enabling legislation in a separate part of the Bankruptcy Act

The *Bankruptcy Act* would be amended to create a separate part applicable to proposals by insolvent farmers. The federal government would be responsible for the administration and the expenses of farmers' proposals. The legislation would provide for:

- a 60-day stay period;
- a committee of financial and farming experts to assist the farmer in negotiating with creditors and in preparing a proposal to creditors; and
- assurance that the farmer would not be automatically bankrupt if the proposal to creditors did not succeed.

The 60-day stay period would be initiated by a farmer filing a Notice of Stay with a court as designated by each province and with the Official Receiver. All proceedings by secured and unsecured creditors would be stayed for 60 days subject to any creditor applying to the court to vary or remove the stay on the basis of a material erosion in that particular creditor's rights or security. This would be particularly applicable to perishable property or property likely to depreciate rapidly in value. The court would have the same powers to shorten or extend the stay period or vary the scope of the stay as are set out in the preceding chapter dealing with secured creditors.

The proposed stay period of 60 days is longer than that suggested for commercial reorganizations in order to provide

sufficient time for a committee of specialists to meet with and assist the farmer, who has the additional responsibilities of operating a farm. The committee would be given the right to apply to the court for a further stay of not more than 60 days if it is unable to complete its work with reasonable diligence. The lack of adequate administrative personnel or insufficient committees would not justify a further extension of the stay.

Upon the filing of the stay, the debtor would also be required to provide the clerk of the court, possibly the same clerk as set out in Part X of the *Bankruptcy Act*, with a listing of creditors, secured and unsecured, and a description of assets. The clerk of the court would forthwith notify all creditors of the stay and set up a farmer's advisory committee. This committee would comprise a chairman and two other members with knowledge of farming, as well as accounting and/or banking experience. During the 60-day period, the committee would investigate the farmer's affairs and meet with the farmer and creditors, to determine:

- o the degree to which the debtor has made a sincere and reasonable attempt to meet past commitments to the creditors;

- o the willingness of secured creditors to postpone payment of their indebtedness, to convert a portion of their indebtedness to equity, to write off a portion of their loans to enable the business to continue, or to accept a transfer of a portion of their security, possibly with some cash as settlement of their claim; and

- o the feasibility of financing the proposal and the future viability of the business.

If the proposal is filed on or before the expiry of the 60-day stay period, the court would have the power to extend the stay until the creditors vote on the proposal, subject to the rights of any creditor to object to the extension of the stay on the basis of a material erosion of the creditor's rights or security.

If a restructuring of debt or a settlement with the creditors was achieved during the 60-day period, the committee would file a report with the court and the farmer would have the option of either filing a proposal or discontinuing the stay without filing a proposal. The filing procedures would be the same as those set out in Part III of the *Bankruptcy Act*. However, if the proceedings had been initiated under the proposed part dealing with farmers and the propo-

sal failed, the farmer would not automatically be bankrupt, although the claims of secured creditors would no longer be stayed. If the farmer had come to terms with the creditors with the assistance of the farmer's advisory committee and decided to terminate the stay without filing a proposal, there would be no automatic bankruptcy.

This option reduces the intervention of the court and would protect a farmer who was negotiating with the creditors and preparing a proposal. To encourage lending institutions not to tighten up on the amount of credit available to farmers, there would be stringent penalties imposed on any farmer who fraudulently disposed of any property during the 60-day stay period. In addition, any secured creditors would have the option of either appointing a monitor to inspect and obtain all relevant information relating to the assets covered by their security or funding the appointment of an interim receiver to take control of the secured assets but not interfere with the carrying on of the farmer's operations. If the advisory committee became aware of any fraudulent conveyances by the farmer during its review, the committee would be required to advise the court forthwith and the 60-day stay period would be terminated immediately. The clerk of the court would advise the Official Receiver of the outcome of the 60-day stay.

Option D - Maintain the status quo

Under this option, farmers would be treated as other debtors with the exception that a farmer could not be petitioned into bankruptcy. There would be no mechanism for staying the proceedings of secured creditors, and a farmer who made an unacceptable proposal to the creditors would automatically be deemed a bankrupt.

Recommendations

1. Where farmers are in financial difficulty we recommend a combination of options (B) and (C) wherein farmers are provided with a choice of either (i) proceeding in accordance with the provisions set out in the section on commercial reorganizations or (ii) proceeding in accordance with special provisions to be set out in a separate part of the *Bankruptcy Act* for farmers' proposals.

2. The recommendations set out in the section of this report dealing with the seizure of assets by a secured creditor and the appointment of a receiver should apply to all insolvent debtors including farmers. Such recommendations would require a secured creditor to obtain leave of

the bankruptcy court before seizing all or substantially all the assets of an insolvent farmer essential for the conduct of the farmer's business.

3. The definition of a farmer should be expanded to include a corporation or partnership deriving all or substantially all of its income from farming if all the shareholders or partners are individuals related to each other.

4. The provisions of this report dealing with secured creditors which recommend that the bankruptcy court should be granted the power to stay proceedings by secured creditors should apply to secured creditors of farmers.

Solutions - Farmers as Creditors

Option A - Provide for another super priority up to $5,000

This option would ensure that farmers received at least a partial payment on delivery of perishable goods. However, another class of creditors would be created, making it difficult for debtors to work out a feasible arrangement or proposal with all creditors. In addition, offering special protection to one sector of the economy would again create controversy.

Option B - Provide farmers with the same priority under the Bankruptcy Act as provided for in the Bank Act

The limitations of Section 178(a) of the *Bank Act* are set out earlier in this paper. However, this option may be a feasible means of providing limited protection to farmers.

Option C - Maintain the status quo

Farmers have some protection under Section 178(6) of the *Bank Act*. Under this option, no additional special treatment would be provided.

Recommendation

Where farmers are creditors, we recommend Option C, wherein the status quo is maintained.

SECURITIES FIRMS, INSURANCE COMPANIES AND FINANCIAL INSTITUTIONS

General

Current Law

Securities firm insolvencies are currently handled under the *Bankruptcy Act* although there are no references in the Act to securities firms or to any of the peculiar aspects of securities firm insolvencies. The insolvencies of insurance companies, trust and loan corporations, banks and credit unions are administered under the *Winding Up Act* because they are specifically excluded from treatment under the *Bankruptcy Act* by Section 2 of that Act.

Background

The insolvencies of securities firms, insurance companies, trust and loan corporations, credit unions and financial institutions, while relatively infrequent in occurrence, raise complex problems with which the present legislation was not designed to deal. As a result these insolvencies are characterized by inconsistency of treatment, inefficiency, delays, higher costs and lower recoveries. Moreover, each of these insolvencies has potentially devastating effects on thousands of customers of the insolvent firm, at least for that portion of their claim that is not protected by some form of insurance or contingency fund.

The financial services sector of the economy is in a period of considerable transition due to

- the continuing consolidation of securities firms and the poor operating results for many of those involved primarily in the agency side of the business;
- the massive losses suffered by property, casualty and liability insurers;
- the reported need to provide backup liquidity funding to the credit unions in Alberta as a result of their accumulated deficits, asset writedowns and operating losses;
- the insolvency of 13 trust and loan corporations as a result of fraud or mismanagement and the continuing difficulties of a further number of these entities, in part due to the decline in Western Canadian real estate value; and

- o the recent collapse of two Canadian chartered banks.

For many years it has been recognized that the existing insolvency legislation in Canada did not deal adequately with the highly complex issues that arise in the insolvency of financial institutions. As a result, the draftsmen of Bill C-17 attempted to define special rules as follows.

- o S.265(14) proposed an order of priority for distributions payable out of the estate of a bankrupt bank.
- o S.265(15) proposed an order of priority for distributions payable out of the estate of a bankrupt financial institution.
- o S.265(16) defined a financial institution to include:
  - a credit union
  - a caisse populaire
  - a trust company
  - a loan company
  - a mutual fund
  - an investment contract company, or
  - any like institution other than a bank that accepts deposits or payments...
- o Part VII (S.318-S.330) proposed very detailed rules for dealing with securities firm insolvencies.
- o Part VIII (S.331-S.353) proposed very detailed rules for dealing with insurance company insolvencies.

Securities Firms

Background

Over the last 20 years fewer than 10 securities firms have been liquidated pursuant to formal insolvency legislation. Many times this number have been merged with healthier firms as a result of the pressure and influence of the self-regulatory organizations such as the stock exchanges and the Investment Dealers Association.

The precedents that have determined how these firms are treated in bankruptcy have been developed principally in the Waite Reid, Stanbury Investments and Malone Lynch Securities insolvencies. The first two were administered before the advent of the National Contingency Fund; the third was the first securities firm insolvency handled with the assistance of that fund. The main principles relating to the handling of customers' accounts in all these cases may be summarized as follows.

- If safekeeping securities are on hand in sufficient quantity and are earmarked, they are returned to the claimants.

- Pending transactions (i.e., those that are between trade date and settlement date) are not completed.

- Margin accounts are liquidated and the margin account debtor becomes a creditor for the equity in the account.

- Cash account transactions are completed if, on an individual security-by-security analysis, sufficient shares of a class and type of security are available to meet all claims. If insufficient securities of a class and type (e.g. Bell Canada - common) are available, all shares of the class and type are liquidated and all claimants are creditors for the cash value of the security at the date of bankruptcy.

- All creditors (i.e., both client creditors and suppliers of goods and services) rank pari passu against one pool of asset recoveries.

Problems

The present approach is both inefficient and inequitable for the following reasons.

- Whether a customer obtains delivery of a security or is a creditor for cash depends as much on luck as anything else.

- Complex analyses are required to determine whether sufficient securities of a class and type are available in the estate. This involves delay and uncertainty as to whether customers have completed transactions or whether they should process the transaction in question through another securities firm.

- Substantial liquidations of securities are involved, creating significant costs for commissions and administrative expenses and causing exposure to market fluctuations. The customer, not the estate, should be exposed to the risk of market fluctuations.

- Suppliers of goods and services and judgement creditors should not share in the assets that rightfully belong to the securities customers. They should look to the general assets of the firm, such as furniture and fixtures.

- Self-regulatory bodies cannot petition for the appointment of a trustee unless they are a creditor.

Recommendations

A model for dealing with insolvent security firms has been proposed in previous draft legislation. It was carefully developed in close consultation with the self-regulatory organizations. In the committee's opinion it is a sensible and well-thought-out plan which should be incorporated by amendment to the existing Act at the earliest possible date. In essence, it proposed two approaches.

Approach A should be utilized if the insurer, such as the National Contingency Fund agreed to protect all customer creditors for unlimited claims. Under this approach the trustee is given extremely wide powers, including the power to

- borrow money;

- complete transactions;

- purchase missing or deficient securities;

- make delivery in cash or kind; and

- prorate available securities among competing claimants.

The trustee administers two separate funds for creditors: a "Customers Fund" comprising the securities assets of the firm and a "General Fund" comprising all other property of the firm. These are administered under two distinct schemes of distribution.

The trustee administers the firm in a manner analogous to an organized gradual wind-down of operations.

Approach B should be utilized if the insurer declined to protect all customer creditors for the full amount of their claim. Under this approach the trustee is required to follow the basic approach as set out by the recent precedents referred to above. Under either approach, the claims of related customers and deferred creditors (being those who contributed to the cause of the bankruptcy) should rank behind the claims of all other customers.

The committee recommends that a brief consultation be held with representatives of the securities industry to ensure that such recently developed new products as financial futures, options and contracts have been appropriately anticipated by the draftsmen of the proposed legislation and that no significant further amendments are required.

Insurance Companies

Background

During the last 20 years a relatively small number of insurance companies have been liquidated pursuant to formal insolvency legislation. Frequently the liquidator has been the Superintendent of Insurance, who normally retains a licensed trustee to act as his agent in administering the liquidation. The liquidator may reinsure the policies issued in order to provide the protection sought by the customer rather than cancelling the insurance and making the customer a creditor for the unamortized balance of the premium. At present the order of priorities is as follows:

- liquidation costs;
- wage earner claims for up to three months' arrears;
- claims under policies and unearned premiums;
- claims of other creditors.

Problems and Issues

The present legislation is deficient in many respects.

- Administration is excessively legalistic.
- Unnecessary delays and costs are incurred.
- The *Winding Up Act* does not contemplate the sophistication of the new insurance products that have been created since the Act was written.

- o Inconsistent treatment of expenses exists, depending upon the jurisdiction and the applicant for the winding-up order.

A model for dealing with insolvent insurance firms was also proposed in previous draft legislation. This model was not as well-developed as the one proposed for securities firms. Consequently, while many of the concepts are sound, a number of areas of concern exist.

- o The term "surety" is not included in the definition of "policy."
- o The issue of who bears the administration costs - the industry or the estate - is not completely clear.
- o The decision-making process in the event of a delayed creditors' meeting is potentially hindered.
- o There are conflicting provisions between provincial insurance legislation and the proposed model, relating to claims in the warranty period under a performance or consumer bond under the provincial insurance acts or other legislation requiring the posting of bonds.
- o Inequities and administrative difficulties could occur as a result of the conflicting provisions of the proposed model and the normal treatment of large deposits lodged with provincial superintendents of insurance to help protect policyholders in individual provinces.
- o The proposed model does not clarify the application of deposits held for a specific group of policyholders and what happens if such deposits have been commingled with other assets.
- o Insurance companies should not be able to act as trustee for their own employee pension plan.
- o Reinsurance of existing policies should not require inspector approval because of the potential time delay; court approval should be sufficient.
- o Claims for unearned premiums are accorded a different priority for life insurance policyholders (pari passu with other claims) and general insurance policyholders (postponed to other claims).

- o A deemed allocation of commingled assets between life business and general business is based on claims experience. An allocation based on premium income would be more equitable and administratively simpler.

- o More work is required on the provisions dealing with surety contracts relative to collateral conversions and recoveries from indemnitors.

Recommendations

The proposed legislation for insurance companies is not ready for implementation at this time. It should be amended to reflect the realities of the problems encountered in recent insurance company insolvencies. The rationalization of the industry in the coming years requires that good workable rules for dealing with insurance company liquidations and insolvencies be included in the *Bankruptcy Act* at the earliest possible date. It is recommended that a task force be set up to advise the Minister on appropriate amendments to both the *Bankruptcy Act* and the *Winding Up Act*.

Trust Companies and Corporations

Background

A number of alternative approaches are currently being followed in the administration of trust and loan corporation insolvencies:

- o appointing a provisional liquidator under the *Winding Up Act* ;

- o appointing a permanent liquidator under the *Winding Up Act;*

- o taking possession by the Federal Superintendent of Insurance/Provincial Registrar of Loan and Trust Corporations under the rehabilitation sections of the appropriate legislation. These regulators then enter into an "Agency Contract" with an independent third party (either another company in the same business or a firm of licensed trustees) to manage the business on their behalf.

Problems and Issues

The following are some of the issues that have been noted in the administration of recent trust company failures.

1. A winding-up order may be made by the court

   - o on a shareholder resolution;
   - o on insolvency; or
   - o when just and equitable.

There is no provision to make an order on the application of the Canada Deposit Insurance Corporation, which is the insurer of all deposits up to $60,000. The liquidator does not have to be a licensed trustee.

2. It is not clear what happens to deposit liabilities (e.g., Guaranteed Investment Certificates) on the making of a winding-up order.

   - o Do they accelerate?
   - o Can they be left to be honoured as they mature?

3. If the insurer wishes to fund the operations and continue the business as a going concern until a sale can be made, certain issues arise.

   - o Can the insurer make advances and take security that may be to the prejudice of uninsured creditors despite the provisions in loan and trust legislation creating a separate "guaranteed fund" and "company fund"?
   - o How are new deposit liabilities treated?

4. On liquidation:

   - o Can depositor liabilities and general creditor liabilities be separated into two funds and distributed accordingly (similar to securities firms)?
   - o How should the trustee be compensated for the work involved in distributing to claimants the very substantial Estates, Trusts and Agency assets ("E.T.&A.")?
   - o E.T.&A. assets should not vest with the trustee.

5. Are government deposits with a trust company preferred claims? In the committee's view the only justification for Section 107 of the *Bankruptcy Act* is that the Crown is obliged to give credit regardless of the credit rating of

the debtor in such instances as payroll deductions and retail sales tax. In Section 265(15), Bill C-17 proposed that Crown deposits have a priority status.

6. Non-arm's length depositors/creditors and those contributing to the causes of the insolvency should be postponed to arm's length creditors (similarly to the provisions in Bill C-17 relating to securities firms).

7. Lawyers' trust accounts and brokers' trust accounts have created major problems when they are lodged with a trust company that becomes insolvent. Should the balances permitted to be placed in these accounts be limited to the insured amounts? Is the account treated as one account or is each separate trust beneficiary an insured depositor?

Banks

Background

The recent collapse of two Canadian banks has illustrated the very inadequate and archaic state of the law applicable to insolvent banks. Both Part II of the *Winding-Up Act* and Part XI of the *Bank Act* contain provisions relating to insolvent banks. Other sections of the *Winding-Up Act* also apply to the winding up of insolvent banks and Section 85 of the *Canadian Payments Association Act* grants certain priority in the distribution of the assets of an insolvent bank.

Problems and Issues

The following are some of the difficulties which have been noted in the winding up of the banks:

1. Section 153(2) of the *Winding-Up Act* requires the court to direct meetings of creditors and shareholders before making a winding-up order in order to ascertain their respective wishes as to the appointment of liquidators. This section appears to apply to the winding up of both solvent and insolvent banks. It is difficult to understand why a meeting of shareholders is necessary in the case of an insolvent bank since there is very little chance of any distribution to the shareholders if a bank is insolvent. Also, the section is so poorly worded that there is a genuine difference of opinion as to whether a winding-up order may be made before the meetings are held.

2. Section 28 of the *Winding-Up Act* permits a provisional liquidator to be appointed upon the presentation of the petition for a winding-up order or at any time thereafter. Section 278(1) of the *Bank Act* gives the Minister of Finance the right to appoint a curator to supervise the business and affairs of a bank until a liquidator is duly appointed. Does this preclude the right of the court to appoint a provisional liquidator? There also has been a considerable divergence of opinion as to the powers which may be exercised by the curator. It is not clear as to whether the curator has the power to give directions to the officers of a bank and, if so, to what extent can the curator interfere with the normal business and affairs of the bank.

3. Section 94 of the *Winding-Up Act* provides that the costs of administration of a winding-up are payable out of the assets of a bank in priority to all other *claims. However, Section 277(1) of the* Bank Act provides in the case of the insolvency of a bank, except for indebtedness evidenced by bank debentures, any amount due to the Government of Canada shall be the first charge on the assets of the bank and amounts owing to a province shall be a second charge on such assets. No mention is made of the priority to be granted to the costs of administration.

4. Neither the *Winding-Up Act* or the *Bank Act* grant any powers or rights to the Canada Deposit Insurance Corporation although it is the insurer of all deposits up to $60,000.00 and usually has the largest financial risk in the event of an insolvency of a bank.

Recommendation

The committee recommends that a task force be created to develop recommendations for proposed amendments to the current *Bankruptcy Act* relative to the insolvency of these important financial institutions. The goal should be to develop a model for dealing with these insolvencies in a manner similar to the model for securities firms. Such provisions should offer maximum flexibility to ensure the most cost-effective administration of the insolvency if an insurer protects all customer creditors. Further, two separate schemes of distribution should be created, one for customers/depositors and one for other creditors.

INTERNATIONAL INSOLVENCIES

Current Law

There are no provisions in the present *Bankruptcy Act* relating to international insolvencies. The Act does not contain any sections dealing with the recovery of a bankrupt's property located in a foreign jurisdiction or recognizing and giving force to the insolvency laws of a foreign jurisdiction. The legal position of the trustee in Canada is clear. The property of the insolvent vests in the trustee on the occasion of the bankruptcy. In this context, "property" means all property of the insolvent, wherever in the world it is located.

The right of the Canadian trustee to recover possession of a Canadian insolvent's property that is located in a foreign jurisdiction will be governed by the laws of that jurisdiction.

Problems

Cross-boundary international insolvency problems are today a common occurrence. Typically the problem will arise in circumstances where a debtor carries on business in both jurisdictions and upon the insolvency or formal bankruptcy of the debtor, assets and creditors remain in each separate jurisdiction. This is a recurring situation, particularly in the immediate vicinity of the Canada-U.S. border in areas of both countries where traditionally cross-border trade is prevalent.

A major problem arises when either a Canadian trustee in bankruptcy seeks to recover the assets of a Canadian insolvent that are located in a foreign jurisdiction or when a foreign trustee attempts to recover assets belonging to a foreign bankrupt that are located in Canada.

The insolvency laws of foreign jurisdictions are often designed to protect the creditors resident in the foreign jurisdiction at the expense of other creditors. Under such circumstances the foreign creditor's claims will be satisfied first before any of the debtor's assets in that jurisdiction become available to the Canadian trustee. In these situations it is usually not possible or practicable for the Canadian trustee to pursue recovery.

Without more, nothing in Canadian insolvency law will require that such law be recognized or be of any force whatsoever in a foreign jurisdiction. The "more" would be provisions in the laws of the foreign jurisdiction, or

perhaps provisions in a treaty between Canada and that foreign jurisdiction, recognizing the efficacy of the provisions of Canadian insolvency laws in that other jurisdiction.

Similar considerations apply to the recognition or force in Canada of the insolvency laws of a foreign jurisdiction. The difficulties facing a Canadian trustee seeking to recover assets located in a foreign jurisdiction are identical to those faced by a foreign trustee seeking to recover assets located in Canada. In the absence of provisions in Canadian insolvency law, or provisions in a treaty between Canada and a foreign nation recognizing the provisions of that nation's insolvency laws and the rights of foreign trustees in Canada, such foreign laws will be of no force in Canada.

Recommendations

1. The *Bankruptcy Act* should be amended to become more compatible with the bankruptcy legislation of other jurisdictions. It should make provision for international insolvencies, thus facilitating the ability of a Canadian trustee to be effective in the international insolvency arena. This should be particularly true in the case of the United States, Canada's largest trading partner and the country where the majority of the Canadian cross-boundary insolvency problems do and will occur.

2. The *Bankruptcy Act* should be amended to provide for the recognition, in Canada, under certain circumstances, of a foreign representative having rights and duties analogous to those of a Canadian trustee. Such recognition should be granted where a foreign court in a bankruptcy matter has made an order seeking the aid of a Canadian bankruptcy court. In such an instance the Canadian court should be entitled to exercise in regard to the matters specified in the order such jurisdiction as it could exercise in regard to similar matters within its jurisdiction.

3. Where property of a bankrupt is situated outside Canada and a creditor receives all or any part of that property, its value should be taken into account when the Canadian assets of the bankrupt are distributed. No dividend should be paid to such creditor until every other creditor has received a dividend equal to the percentage that the value of the property received by that creditor bears to the total claim of that creditor.

4. The *Bankruptcy Act* should be amended by providing guidelines to the court when such relief is sought. Certain provisions set out in the United States Bankruptcy Code

should be adopted. These include the provision that "the court shall be guided by what will best assure an economical and expeditious administration" of the assets involved in the proceeding which are located in Canada, consistent with the following factors:

- o just treatment of all creditors and shareholders;
- o protection of creditors in Canada against prejudice and inconvenience in processing claims in the foreign proceedings;
- o determination of the balance of convenience of the parties involved;
- o assessment of the nature, type and location of assets involved in the proceedings;
- o recognition of the rights available in Canada that may not be available in the foreign jurisdiction;
- o prevention of preferential or fraudulent dispositions of property involved in a foreign proceeding;
- o distribution of proceeds of property involved in the foreign proceeding substantially in accordance with the order prescribed by Canada law;
- o comity; and
- o if appropriate, the provision of an opportunity for a fresh start for an individual involved in the foreign proceeding.

5. A treaty with the United States relating to bankruptcy and insolvency matters should be considered. Several years ago a draft bankruptcy treaty was submitted by the United States, but it has not been reviewed by this committee since it was outside our terms of reference. Two significant issues would have to be resolved in such a treaty. The first is the connecting factor; that is, the factor determining the jurisdiction in which the bankruptcy should be administered. Some possible connecting factors are the principal place of business of the bankrupt, the bankrupt's legal domicile such as the jurisdiction where the bankrupt corporation was incorporated or the country where either the bulk of the bankrupt's assets are located or the bulk of the assets available for distribution among the unsecured creditors are located. The second major issue is determining what legislation governs the rights of the parties. For example, if the bankruptcy is administered in Canada, should Canadian law govern the rights of a creditor holding a mortgage on land in California.

ESTATE ADMINISTRATIVE MATTERS

Trustee's Fees

Current Law

The remuneration of the trustee may be fixed by an ordinary resolution of the creditors at a meeting of creditors. Where the remuneration is not so fixed, then pursuant to Section 21(2) of the *Bankruptcy Act*, the trustee may retain as remuneration, subject to increase or decrease by order of the court, a sum not exceeding 7½% of the realization of the property after the claims of secured creditors have been paid or satisfied. The remuneration of the trustee may be varied by the court. Other than in sections 116 and 117, which deal with interim advances to trustees on account of fees in summary administrations, the *Bankruptcy Act* does not provide for payment of interim fees to trustees.

Background

The inspectors must satisfy themselves that the remuneration of the trustee is just and reasonable. The inspectors, of course, have worked with the trustee during the course of the administration and are aware of the time spent by the trustee in the overall administration of the estate and in dealing with any problems that may have arisen.

Many bankruptcy estates may be open for some considerable period of time, particularly if litigation is involved, as the courts are backlogged and the inability to bring a matter on for trial can delay the completion of the administration of an estate by as much as two years.

The present practice in certain provinces requires a trustee to obtain the approval of the inspectors and an order of the court before any advance on account of fees is drawn. Trustees trustees should be encouraged to complete the administration of estates and wind them up as quickly as possible. Therefore, the trustee should not be advanced all the fees to which it might be entitled; some portion of the fees should be held back as an incentive to see the estate completed.

Problems

The provisions of the existing Act relating to the remuneration of the trustee do not reflect current business practice. Substantially more creditors now take security when lending money or providing services than was the custom when the *Bankruptcy Act* was enacted. As a result, the realization of assets in an estate is substantially reduced because more and more assets are pledged to secured creditors.

The taxation process in areas other than the *Bankruptcy Act* is only invoked when a creditor or a party takes objection to an account rendered by another party and requires taxation by the court to justify the amount. Under the existing *Bankruptcy Act* the approval of the court is required in all circumstances; as a result, in the vast majority of situations the courts are asked to approve accounts rendered by a trustee that have already been approved by the inspectors in the estate.

Solutions

1. Leave the *Bankruptcy Act* as it is presently written.

2. Reduce court involvement and increase creditor involvement by giving the inspectors the additional responsibility of approving the trustee's fees without the trustee having to proceed to the court for taxation.

3. Allow for greater involvement by the Superintendent of Bankruptcy in the area of supervision of trustee's fees by giving the superintendent the right to approve trustee's fees. This would provide for greater consistency of application from region to region. The provincial laws of most jurisdictions that interact with the federal *Bankruptcy Act* are basically the same, so the fees charged by trustees should not vary disproportionately from one region of the country to another.

4. Reduce administration costs by reducing the trustee's overhead. This could be done by allowing the trustee to obtain advances on account of fees and thus reduce the cost of borrowings presently incurred by trustees in financing their work in process.

5. Preserve the rights of creditors or other interested parties to object if they perceive that the trustee and the inspectors are not acting properly. If a creditor or the Superintendent of Bankruptcy object to the trustee's fee, the trustee would then be required to proceed to the taxation of its account pursuant to the provisions of the existing *Bankruptcy Act*.

Recommendations

1. Remove the requirement for court taxation of a trustee's fee that has been approved by the inspectors or creditors, unless a creditor or other interested party files an objection within 30 days. Should there be an objection, the trustee must proceed to taxation of its accounts, electing to appear before the registrar or a judge of the bankruptcy court.

2. Allow the trustee to draw advances on account of fees subject to the approval of inspectors, provided that the amount to be drawn does not exceed 85% of amounts approved by the inspectors. In special circumstances, where the completion of the administration of the estate was unduly prolonged, the trustee should have the right to apply to the court for permission to draw fees up to 100% of amounts previously approved by the inspectors.

3. The aforesaid provision should not be applicable to summary administration, or what will be called under the proposed amendments Consumer Debtor Bankruptcies. Sections 116, 117 and 118 of the existing *Bankruptcy Act* should remain in force for summary administrations and consumer bankruptcies.

4. If the trustee and the inspectors cannot agree on the amount of the trustee's fee, the trustee should have the right to elect to have the account taxed before the registrar or a judge of the bankruptcy court in a manner similar to the existing provisions of the *Bankruptcy Act*.

5. If the Superintendent of Bankruptcy is concerned that a trustee is not diligently completing the administration of estates and winding them up in a businesslike fashion, then the Superintendent should have the power to suspend a trustee's ability to draw interim fees on account of all estates in process.

6. If there are no inspectors, or the trustee's fee is not set at the first meeting of creditors, the trustee should be required to have the account taxed before either the registrar or a judge of the bankruptcy court.

7. If the trustee's fees are substantially upheld on a taxation initiated by an objecting creditor or other interested party, the trustee should be allowed to claim against the estate for the time spent in the preparation for the taxation and the attendance at same. This provision should not prejudice the right of the court to award costs against the objecting party.

8. The remuneration of the trustee should not be based on 7½% of the amount of the realization from the property of the bankrupt after secured creditors have been paid or satisfied. The remuneration should be determined by having regard to all the circumstances, including the work done by the trustee, the responsibility imposed on the trustee, the time spent in doing the work, the reasonableness of the time expended, the necessity of doing the work and the results obtained.

Receiver's and Receiver-Manager's Fees

Current Law

Under the existing *Bankruptcy Act* the bankruptcy administration or the Superintendent of Bankruptcy's office has no control over the actions of and fees charged by receivers and receiver-managers. Any right to challenge such fees arises as a result of provincial law.

Background

The duties and powers of receivers vary from jurisdiction to jurisdiction across the country and the accountability of receivers, the information they must provide, and the conduct of the receivership generally vary from province to province based on the statutes and case law precedents in force in various jurisdictions.

More and more Canadian insolvency proceedings are taken by way of receivership rather than bankruptcy because of the lending practices of financial institutions in Canada and the security documentation they receive in support of the moneys lent.

Problems

It has been alleged that in some instances secured creditors, agents for secured creditors, receivers, receiver-managers and others have withheld information from creditors of a company that may have gone into receivership. In many provinces the only method of challenging the actions and fees of a receiver is by bringing a civil court action, which is expensive and time consuming.

Where a company receivership occurs today and a bankruptcy does not necessarily follow, the moneys payable to creditors in the administration of the receivership vary in their priority from a bankruptcy proceeding. As a result, some creditors receive a priority or preferential payment

that they would not enjoy in a bankruptcy proceeding. If the ultimate result of the receivership is the liquidation of the corporation and the distribution to creditors of the proceeds from the sale of the assets, it seems only equitable that the priorities as set out in the *Bankruptcy Act* should be followed in this type of situation.

Solutions

1. Introduce provisions in the *Bankruptcy Act* requiring a receiver to report to the trustee and inspectors and to provide an accounting in those cases where the corporation is insolvent.

2. Leave matters as they are, with receiverships under the control or supervision of the provinces.

3. Give the bankruptcy court the power to approve the accounts of a receiver of an insolvent company.

Recommendations

The following recommendations only deal with the fees and disbursements of a receiver and are primarily based on two assumptions:

- o that the *Bankruptcy Act* is amended to provide for some control over receivers;
- o that if a bankruptcy occurs, the trustee in the bankruptcy will be a separate and distinct party from the person or firm acting as the receiver.

1. Provisions of the *Bankruptcy Act* regarding the priority of the payment of creditors' claims should be followed if a bankruptcy is in place at the same time as a receivership is in place.

2. An instrument-appointed receiver should be required to tax its accounts at the request of the trustee in bankruptcy.

3. In cases where there is no bankruptcy, a creditor or a debtor should be required to obtain a court order to have the accounts of a receiver taxed.

4. When taxation of the accounts of a receiver or that person's legal counsel is required by the parties referred to in the preceding paragraphs, the receiver and the legal counsel should be entitled to elect to have the accounts taxed before the registrar or a judge of the bankruptcy court.

Legal Fees in Bankruptcies and Proposals

Current Law

The existing *Bankruptcy Act* provides for the payment of legal fees to solicitors for various services rendered to the trustee, to the bankrupt estate, to a debtor or to a trustee acting under a proposal. The payment of the legal fees is subject to the approval of the inspectors and the trustee, and the bill of costs must be taxed by the court. This bill is first taxed by the registrar and any appeal from the registrar's decision is heard by the judge of the bankruptcy court.

Problems

There has been criticism that the legal fees and trustee fees in bankruptcy estates are too high and that steps should be taken to keep those fees to a minimum.

Legal fees and trustee fees in most bankruptcy estates are higher today than they have been in previous years because more creditors now attempt to take security. This has had the effect of both reducing the receipts available in a bankruptcy for unsecured creditors and at the same time increasing the legal costs necessary to properly administer the estate.

One way of helping to reduce such fees is to abolish any unnecessary administrative procedures. A basic criterion of the existing insolvency legislation is the concept of creditor control. This is accomplished by providing inspectors with the power to oversee the trustee's administration of the estate and to ensure that the trustee only incurs proper expenses in the overall administration.

Solutions

1. The *Bankruptcy Act* could be left in its current state, which requires taxation of every legal account whether or not the size of the account is challenged.

2. The automatic taxation of legal fees could be eliminated if they are approved by the trustee and inspectors, so long as safeguards are available if court control is relaxed.

Recommendations

1. The taxation of legal fees of solicitors for services rendered on behalf of bankrupt estates should not be required if the accounts have been approved by the trustee and the inspectors.

2. The trustee should provide the inspectors with a signed statement attesting that the bill has been examined, the services have been duly authorized and rendered, and the charges are fair and reasonable.

3. If any creditor or the Superintendent of Bankruptcy objects to the trustee's final Statement of Receipts and Disbursements and particularly to the legal fees included therein, the solicitor to the estate should be required to proceed to taxation, with the right to elect to appear before either the registrar or a judge of the bankruptcy court.

4. If the amount of the legal fees taxed by the court is not materially different than the amount approved by the trustee and the inspectors, the solicitor to the estate should be entitled to costs against the estate for the time spent in the preparation and of attendance at the taxation. This should not prejudice in any way the right of the court to award costs against parties who object to the solicitor's fees and have been unable to convince the court that the fees were not properly charged.

5. If the trustee is required to attend at the taxation as a result of an objection filed by a creditor or the Superintendent of Bankruptcy, it should be unable to charge for the time spent at the taxation if the court taxes down the amount previously awarded to the trustee by the inspectors.

6. As there are usually a substantial number of secured claims in most bankruptcy estates, the legal fees often exceed 10% of the net receipts after payments to secured creditors. It is recommended that this limitation provision, which is set out in Section 168(7) of the *Bankruptcy Act*, be deleted.

7. A provision should be added to the Act allowing the solicitor to the estate to render accounts to the trustee from time to time during the administration of the estate. It should also authorize the trustee to pay those accounts with the approval of the inspectors on the understanding that only 85% of the bills submitted would be paid until the estate administration had been completed and the legal fees had been finally resolved. Once the trustee's final Statement of Receipts and Disbursements had been submitted to the creditors and the Superintendent of Bankruptcy and no objection had been received, the balance of the moneys due to the solicitor should be paid out by the trustee.

Remuneration of Inspectors

Current Law

Section 94 of the *Bankruptcy Act* deals with the appointment of inspectors and their duties, powers, and obligations.

Section 94(15) deals with the remuneration of inspectors and provides that each inspector may be repaid for actual and necessary travelling expenses incurred in and about the performance of his or her duties and may also be paid the following fees, to be computed on the net receipts as determined by the amount realized by the trustee, less payment to secured creditors:

- Estates with net receipts below $10,000 - $3.00 fee per meeting;
- Estates with net receipts from $10,000 to $50,000 - $5.00 fee per meeting;
- Estates with net receipts from $50,000 to $100,000 - $7.50 fee per meeting;
- Estates with net receipts over $100,000 - $10.00 fee per meeting.

Background

The inspectors are the creditors' representatives appointed at the first meeting of creditors in a bankruptcy proceeding. The inspectors provide the creditor control envisaged by the *Bankruptcy Act* in that the trustee must obtain the approval of the inspectors before undertaking certain functions in the administration of the estate.

The inspector's fee for attending meetings called by the trustee is woefully inadequate and does not reflect the current economic cost of salaries and wages to employees of creditors who are asked to serve as inspectors in bankruptcy estates.

Notwithstanding the foregoing, it is also fair to assume from the level of the fee set in the existing *Bankruptcy Act* that the fee paid to inspectors was not meant to compensate them fully for the time spent in fulfilling the function. Presumably, the legislators felt that the function of an inspector was somewhat of a social obligation to the rest of the creditors and that over a period of time the obligation would be shared by various creditors, who

would volunteer to act as inspectors in different situations where there was a commonality of creditors in a particular industry. No fee could be set that would properly compensate inspectors for their time.

Solutions

1. Leave the existing *Bankruptcy Act* as it stands.

2. Amend the existing *Bankruptcy Act* to more adequately reflect current financial standards.

3. Eliminate inspectors' fees in consumer bankruptcies.

Recommendations

1. Section 94(15) of the existing *Bankruptcy Act* should be amended to provide for a fee of $50.00 per inspector per meeting, regardless of the amount of the net receipts in the estate.

2. Section 94(15) should be further amended to provide that no fee should be paid to inspectors in consumer bankruptcies.

3. Section 94(15) should be amended to give trustees the power to apply to the court for approval of an increase in inspectors' fees in extraordinary circumstances. Such a power would not be restricted to commercial bankruptcies but would apply to consumer bankruptcies where the estate was of such a complex nature that the trustee believed that the inspectors should be remunerated for their services.

4. Section 94 should be amended to provide that the trustee may convene a meeting of inspectors by conference call. Such a meeting should be deemed to be a meeting in person under the terms of the existing Act and proper minutes should be kept and distributed. No fee should be paid for such a meeting.

DIRECTORS' AND OFFICERS' LIABILITY

Current Law

The present *Bankruptcy Act* treats corporations in almost all respects as if they were individuals. Very few sections of the Act deal with the special circumstances of corporations. Although the corporate veil has frequently been pierced in company, combines and taxing statutes, the *Bankruptcy Act* has made little attempt to do so. Under Section 79 of the Act a trustee may apply to the court for an inquiry as to whether the dividends paid or shares purchased or redeemed within 12 months of the bankruptcy occurred when the corporation was insolvent or rendered the corporation insolvent. In such circumstances the court may, under conditions outlined in that section, give the trustee judgement against the directors jointly and severally for such dividends, redemption or purchase price.

There are no provisions in our *Bankruptcy Act* imposing any liability on directors for unpaid wages and expenses incurred by employees on behalf of companies. However, there is federal legislation, as well as legislation in the provinces of Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec, and Saskatchewan, imposing personal liability on directors for wages.

Background

Unsecured creditors and unpaid suppliers frequently suffer a financial loss that, in their opinion, could and should have been avoided by individuals acting as directors in charge of corporations. Also, the same individuals may incorporate new companies and carry on businesses, become insolvent, bankrupt and shortly thereafter incorporate another company and carry on the same or a similar business with the same disastrous effects for employees and suppliers.

A corporation is a legal entity separate and distinct from its shareholders. As a rule, only the corporation is bound by the actions done in its name or on its behalf, and not its shareholders, directors or officers. The abuse of this rule has posed serious problems in bankruptcy administration. Although corporations are essential in our economic system, it should not be possible to use incorporation as a means of defeating the aims and objectives of a modern bankruptcy system. For example, a man who has been inexcusably imprudent, dishonest or guilty of a serious infraction of the expected standards of commercial morality should be

subject to the same sanctions and disabilities whether he is acting in his personal capacity or as the officer or agent of a corporation.

Over the last 10 years, several bills have been introduced into Parliament containing new provisions concerning the status and personal liabilities of directors and officers of bankrupt corporations. Some contained provisions to prohibit a bankrupt from continuing to act as, or from being elected or appointed, a director of a corporation. They also imposed personal liabilities on directors and officers and former directors and officers (within two years before bankruptcy) for debts of the corporation that remain outstanding as claims against the estate where the director or officer had, for personal gain, breached the fiduciary relationship or continued to carry on business that was not in the best interest of the corporation. Other provisions dealt with the personal liability of directors and officers who commingled various funds. There were also provisions respecting directors' and former directors' liability for wages of employees. None of these bills in their entirety became law.

The most recent, Bill C-17, imposed liability on directors for wages of employees not exceeding $2,000 per employee plus $500 per employee for pension, health and welfare contributions under certain conditions and subject to certain limitations. Section 189 of that bill also imposed liability on agents in the circumstances outlined therein. "Agent" was defined in Section 2(1)(1) of that bill to mean a director or officer of a corporation or any person who is related to the corporation or who has directly or indirectly de facto control of the corporation.

Problem

There should be some mechanism to preclude and prevent dishonest individuals from taking advantage of a limited liability company to abuse the bankruptcy process.

Solutions

1. Legislation has been proposed in Great Britain to provide for the automatic three-year disqualification of directors of insolvent companies from the management of a company where the insolvent companies have been wound up by the court. A distinction was made where companies made a voluntary assignment in bankruptcy. It was further suggested that if persons involved in insolvent liquidations were considered by the court to be unfit for company management, they could be disqualified from holding a directorship for

up to 15 years. These disqualified directors would be entitled to apply to the court to have the disqualification lifted.

2. A person who is a bankrupt could be disqualified from acting as a director or an officer of a corporation.

3. A director of a bankrupt corporation could be automatically disqualified from holding office as a director of a corporation for a period of two years from the date of the bankruptcy.

4. The trustee or Official Receiver could be given the authority to apply to the court for an order disqualifying a director or officer of a bankrupt corporation from acting as a director of a corporation.

5. Section 78 of the *Bankruptcy Act* could be amended to extend reviewable transactions so that, in circumstances where directors were guilty of wrongful conduct, an application could be made to the court to have the transaction reviewed. If it was found to be a deliberate and dishonest effort to defeat creditors, the court could hold the directors personally liable to the trustee for any loss resulting from such wrongful conduct.

6. A director of a company could be personally liable for the loss suffered by creditors to the extent determined by the court if a director allowed a company to continue trading with the result that the position of existing creditors worsened or additional liabilities were incurred which were not paid and the directors knew or ought to have known that there was no reasonable prospect of avoiding that situation. This liability would arise where officers or directors of an insolvent company have authorized the company to make additional purchases of inventory in order to enhance the amount available for realization by a secured creditor whose debt they have guaranteed.

Recommendations

1. Section 2 of the *Bankruptcy Act* should be amended by including the following definition:

"responsible person" means

- in respect of a corporation, a director, or any person who is related to the corporation or who has directly or indirectly de facto control of the corporation,

- in respect of a partnership, any member thereof except a limited partner, and

- o in respect of an individual or partnership, any person,

  - who manages, directly or indirectly, a business in whole or in part on behalf of the individual or partnership, or

  - who has, directly or indirectly, de facto control of a business of the individual or partnership

  but does not include an interim receiver, trustee, or receiver.

Note: This definition is intended to extend the provisions of the *Bankruptcy Act* to cover persons who have no official positions but, in fact, control the affairs of a bankrupt.

2. When a company is declared bankrupt, all responsible persons of the corporation should be jointly and severally liable to the employees of the corporation for wages and expenses owed during their tenure as responsible persons to the extent of the employees' claim for priority as outlined in the "Wage Earner Protection" section of this chapter and subject to the provisions of recommendations 3 and 4 below. If such wages and expenses are paid by the wage earner protection fund and the responsible persons reimburse the fund for such wages and expenses, the responsible persons should be subrogated to the rights of the fund against the estate.

3. Responsible persons of a bankrupt corporation who had no management responsibility should not be liable for the payment of wages of employees if they relied, in good faith, on financial information relating to the affairs of the company supplied by either the management or a professional person and can establish that they had reasonable grounds to believe that the wages would be paid.

4. Responsible persons of a bankrupt corporation who had management responsibility should not be liable for the payment of wages of employees if they relied in good faith on financial information supplied by a professional person and can establish that they had reasonable grounds to believe that the wages would be paid.

5. Where there has been wrongful conduct by a responsible person, the trustee, the official receiver or any interested person, including any creditor, should be entitled to apply to the court to have the responsible person disqualified from acting as a director of any corporation for such period of time as determined by the court. If the court is satisfied that the estate suffered a financial loss as a result

of such wrongful conduct, the court should be entitled to award damages in favour of the estate against the responsible person or persons. For the purposes of this recommendation, wrongful conduct should include inexcusable disregard of commercial morality but should not include a mistake of judgement. Such conduct would be a dishonest or reckless violation of the accepted standards of commercial conduct.

The objective of this recommendation is to deter and penalize wrongful conduct on the part of those who manage a business. The automatic disqualification of directors of a corporation would be unfair. Fraud is very difficult to prove. The middle ground suggested is wrongful conduct. Where individuals are responsible for the wrongful acts of a corporation, they should be subject to the same sanctions and penalties as if they had been acting in their personal capacity.

6. Section 78 of the *Bankruptcy Act*, which deals with reviewable transactions, should be amended so that in circumstances where responsible persons were parties to a reviewable transaction that resulted in a loss to the bankrupt, they should be held personally liable to the trustee for any loss resulting from the reviewable transaction.

7. A person who is a bankrupt should be disqualified from acting as a director or officer of a corporation.

TECHNICAL AMENDMENTS

Avoidance of Transactions, Preferences, Settlements and Reviewable Transactions

Background

The committee has conducted a critical examination of sections 64 through 79 of the *Bankruptcy Act* and recommends the following amendments that would better reflect today's financial and commercial needs.

Recommendations

Sections 64 to 68

These sections, which deal with the sale of hypothecated immovable property in the Province of Quebec, should be repealed. Past experience has shown that these provisions are useless and unduly slow down procedures in the administration of bankruptcies, incur unnecessary costs to the trustee and diminish the dividends in most estates. Also, these sections do not serve to protect anyone, as there is already adequate protection of property rights in Quebec under the Civil Code.

Sections 69 to 79 in General

Provincial legislation

It is recommended that any provincial legislation relating to fraudulent conveyances and fraudulent preferences should continue to be applicable. Creditors often undertake certain recourses prior to the bankruptcy. If the survival of such recourses within the bankruptcy were not ensured, the recourses dealing with fraudulent conveyances and fraudulent preferences would then disappear, especially in certain transition periods between the filing and the granting of the petition for a receiving order.

Proposals and commercial reorganizations

If the creditors so choose, any or all recourses available under either provincial legislation or the *Bankruptcy Act* relating to the avoidance of a transaction should be available to a trustee acting in a proposal unless the proposal specifically excludes them. These rights would include the power to revise, review or exercise all the rights found in sections 69 to 79 when a proposal has been filed.

Section 69

There is a need to clearly define the use of the terms "disposition" or "settlement" found in this section, which have been interpreted with great difficulty both in the common law provinces and in Quebec.

It is recommended that the terms "settlement" or "disposition" be enlarged to speak rather of "donation," "gift," or "contract without consideration."

Such a definition should read as follows:

> "gift includes a contract, covenant, transfer, settlement and designation of a beneficiary in an insurance contract to the extent that such contract, covenant, transfer, settlement or designation is gratuitous or is made for a merely nominal consideration."

The committee believes that this definition adequately covers the use for which it is intended.

Sections 70 to 72

These sections do not give rise to any difficulty of interpretation or application, and the committee recommends that no changes be made in them.

Section 73

Since there has been a considerable amount of jurisprudence on the subject of this section, the committee recommends that the section not be changed.

Section 75

There is a need to define more clearly the use of this section, in light of the judgement in *Hudson* v. *Benallack*, (1975) 21 C.B.R. (N.S.) 111.

Section 75 was intended to allow for transactions made in good faith during the period between the moment of the filing of a petition in bankruptcy and the moment at which the debtor is declared bankrupt following a receiving order.

Subparagraph (e) of Section 75(1) should be amended by deleting the words "before the date of the bankruptcy," and inserting in their place "before the effective date of the bankruptcy," which is the date at which the debtor will become bankrupt; i.e., the date of the receiving order, the date of the refusal by the creditors to accept a proposal or the date of the refusal by the court to approve a proposal.

The purpose of Section 75 is to regulate transactions during the intervening period between the date of the bankruptcy and the date that the debtor actually becomes bankrupt.

A similar problem arises under Section 95 of the *Bankruptcy Act*. Only debts and liabilities to which the bankrupt is subject at the date of the bankruptcy are deemed to be claims provable in the bankruptcy. With respect to a proposal, claims may arise between the date of the filing of the proposal and the date of its refusal by the creditors. The problem may also arise in the period between the filing of a petition of bankruptcy and the granting of a receiving order. Claims created during this period would not be provable in the bankruptcy or discharged. Accordingly, the committee recommends that claims provable in the bankruptcy should be those established at the effective date of bankruptcy; that is, at the granting of a receiving order or at the refusal of a proposal. In the event of an accepted proposal, claims provable would then be established at the date of the filing of the proposal.

Sections 78 and 79

These sections should remain unchanged; however, a new section should be added extending the bankruptcy court powers beyond those already found in sections 78 and 79. When a court sets aside a transfer it should have the power to

- award pecuniary damages against third parties;
- restore as far as possible each party to its state prior to the transfer; or
- allow the trustee to recover the property or its value from the person to whom the bankrupt transferred the property or from any other person to whom the property has been transferred.

In the "Directors' and Officers' Liability" section of this report we recommended that Section 78 of the *Bankruptcy Act* be amended to allow the court to award damages against persons responsible for a loss to the bankrupt estate resulting from a reviewable transaction. If the court concludes that there were any wrongdoings or acts that deliberately caused the bankruptcy or diminished the debtor's property to the detriment of its creditors, the court should have the power to hold the responsible persons of the bankrupt company personally liable for the loss suffered. Such liability should not arise from an error in judgement but rather should result from a dishonest or reckless violation of the accepted standards of commercial conduct.

Section 79

This section, which deals with the payment of dividends, should remain unchanged.

Contingent and Unliquidated Claims

Current Law

Section 95(2) of the *Bankruptcy Act* provides that a creditor with a contingent or unliquidated claim is not entitled to file a claim until the court determines whether it is a provable claim and, if so, values the claim.

Problem

A contracting third party whose contract has been varied as recommended in this report will have a contingent or unliquidated claim. Difficulties will arise in the matter of voting and distribution under a proposal. Under the present law, because of the time involved in valuing the claim, it would be impossible for such a creditor to vote on a proposal. In addition, until a contingent claim is valued, the entire amount of the contingent claim, even if it be for general damages, must be recognized for the purpose of creating a reserve, which must be taken into account before any distribution can be made to the creditors under a proposal.

Recommendations

1. In order to give the creditor with a contingent or unliquidated claim the right to vote on a proposal, the *Bankruptcy Act* should be amended to give the trustee the right to value the claim for voting purposes. A creditor who is not satisfied with the amount of such valuation would be entitled to appeal it to the court subsequent to the first meeting of creditors. This would force the trustee to be reasonable in the valuation in order to avoid having the creditors' meeting declared invalid because of an unreasonable or unfair valuation of the aggrieved third party's claim.

2. The amount of the reserve for distribution purposes should be within the discretion of the court. Accordingly, Section 119(2) of the *Bankruptcy Act* should be amended to give the court the power to determine the amount of the reserve. The amount should not be arbitrarily restricted to the sum that would be payable upon the claim if the claim were allowed in full.

Provisions Relating to Leases

Current Law

Under Section 107(1)(f) of the *Bankruptcy Act*, landlords are entitled to priority for an amount equal to three months' arrears and three months' accelerated rent if covered in the lease, provided goods are on the premises of a value sufficient to cover the amount of the claim. There are no provisions under the present *Bankruptcy Act* giving the trustee of the bankrupt estate the right to occupy the leased premises. Neither does the *Bankruptcy Act* give the trustee the right to assign the bankrupt's interest as lessee in a lease. Certain provinces, including Alberta and Ontario, have provincial legislation giving the trustee such a right.

Most leases also provide that the landlord has the right to terminate the lease in the event that the tenant becomes bankrupt or makes a proposal to the creditors. In some provinces, provincial legislation supersedes this contractual provision and gives the trustee of the bankrupt estate the right to retain the lease and assign it to a third party. However, this right is not available to the debtor when making a proposal. The right of the landlord to terminate a lease when a debtor goes bankrupt or makes a proposal may deprive the bankrupt estate of a very valuable asset or prevent a successful reorganization.

Recommendations

1. The *Bankruptcy Act* should be amended to give the trustee the right to treat a valuable lease as an asset capable of realization.

2. A trustee should be given the right to

   - occupy premises leased to the bankrupt for a period not exceeding the shorter of the unexpired term of the lease and three months from the date of bankruptcy;

   - assign the lease to a third party with the consent of the landlord or the approval of the court. Such approval should be granted if the court is satisfied that

- the proposed assignee has agreed to observe and perform the terms of the lease and not to conduct on the leased property a trade or business that is of a more objectionable or hazardous nature than that conducted thereon by the bankrupt or permitted by the lease;

- the proposed assignee is a fit and proper person to be put into possession of the leased property; and

- the proposed use by the assignee is consistent with the previous use or the terms of the lease.

3. In the case of a proposal or reorganization, the debtor should be allowed to continue to occupy the leased premises as long as all obligations under the lease are fulfilled. Any right of the landlord to forfeit a lease solely because of insolvency or because the debtor has made a proposal to its creditors should be abolished.

New Definitions

Section 2 of the *Bankruptcy Act* should be amended by including the following definitions:

"public utility" means any person or association of persons that owns, operates or manages an undertaking:

(a) for the supply of petroleum or petroleum products by pipeline,

(b) for the supply, transmission or distribution of gas, electricity, steam or water,

(c) for the collection and disposal of garbage or sewage or for the control of pollution,

(d) for the transmission, emission, reception or conveyance of information by any telecommunication system, or

(e) for the provision of postal services.

"secured creditor" means a person having a security interest and includes:

(a) a receiver, and

(b) a person who is appointed to take or who has taken possession or control of substantially all the property of a debtor under a security agreement or pursuant to an order of the court.

"security interest" means an interest in or charge on property to secure the payment or performance of an obligation whether the obligation is liquidated or not, absolute or contingent.

"transfer" includes:

(a) a payment or a set-off,

(b) the incurring of an obligation,

(c) any mode, direct or indirect of rendering services, and

(d) any mode, direct or indirect of disposing of or parting with existing or future property, any interest therein or the possession thereof, whether absolutely or conditionally, voluntarily, under pressure or by judicial proceedings.

Note: The term "set-off" does not mean the balancing of accounts in a financial institution.

"trust indenture" means any deed, indenture or other instrument including any supplement or amendment thereto made by a corporation under which the corporation issues debt obligations and in which a person is appointed as trustee for the holders of the debt obligations issued thereunder.

Miscellaneous Amendments

The following technical changes should be included in the amendments to the *Bankruptcy Act* for the purpose of improving the administration of bankrupt estates.

1. A trustee should be given the right to a hearing when the Superintendent intends to cancel or impose conditions on the trustee's licence.

2. The Superintendent of Bankruptcy should be given the power to take conservatory measures when a licence of a trustee has been cancelled. This power should include the power to appoint another trustee.

3. An interim receiver or trustee should be released from any liability for any statement made or opinion expressed without malice or from any non-contractual liability arising from the possession of property or the operation of a business where the duties of such person are carried out in a reasonably prudent and diligent manner.

4. A person who is acting as interim receiver, trustee, receiver, solicitor or inspector in a matter, or any person who is employed by or related to such a person, should only be entitled to acquire the property of the bankrupt estate or under the control of the receiver if the approval of the court is obtained.

5. The present practice of requiring bonds for each estate should be abolished. The Superintendent of Bankruptcy should be given the power to increase or decrease the general bond filed by each trustee dependent upon the number and size of the estates under the administration of the trustee.

6. A trustee should be given the power to issue a certificate confirming that a proposal has been fully performed.

7. Unless the proposal otherwise provides, where a proposal is annulled the date for determining whether or not a transfer may be set aside should be the date the Notice of Stay or proposal was filed.

8. The Attorney-General of Canada or an attorney-general of a province should be given the right to file a petition for a bankruptcy receiving order in respect of a debtor either as a creditor or in accordance with the provisions of other legislation. The Attorney-General of Canada should be given the right to file a petition for a bankruptcy receiving order in respect of a bank, and the *Bank Act* should be amended to set out the circumstances when such a petition may be filed.

9. Where a bankruptcy receiving order has been made, all proceedings under a statute for the liquidation or dissolution of a corporation should cease unless the court otherwise orders.

10. There should be a prohibition against termination of a security agreement or a claim for accelerated payment by reason only of the insolvency of a debtor or by reason of any proceeding taken in consequence thereof.

11. Proceedings by an unsecured creditor should be stayed when a petition for a bankruptcy receiving order is filed.

12. Upon receipt of an amount equal to the cash surrender value of an insurance policy the trustee should be required to assign the policy to the bankrupt.

13. A bankrupt who is a disabled person should be given the right to retain, without limitation as to amount, funds payable under an insurance contract, a retirement income fund, a retirement savings plan, or a pension fund or plan as exempt assets.

14. The trustee of a bankrupt estate should be given the power to administer property held in trust by the bankrupt, subject to the right of the beneficiaries to apply to the court for an order changing the trustee.

15. There should be an automatic vesting in the trustee of a bankrupt estate of all the rights of the bankrupt in an insurance contract except for insurance policies that are exempt from execution and do not vest in the trustee of the estate.

16. The trustee of a bankrupt partner should be given the right to institute proceedings relating to the partnership and to restrict releases that may be given by other members of the partnership.

17. The trustee of a bankrupt estate should be personally liable for occupation rent if he or she either occupies the leased premises for more than three weeks after being appointed or permits a secured creditor to take possession of property on the leased premises. In the latter case, the secured creditor should be required to pay to the trustee the amount of such occupation rent.

18. Either a trustee or a receiver, whoever is first appointed, should be required to make an inventory of the property of the debtor. A receiver who makes such an inventory should be required to remit a copy of it to the trustee.

19. A trustee should not be required to insure property of the bankrupt unless there is equity in the property for the bankrupt estate, provided that notice of the fact the property is not insured is given to all known secured creditors.

20. Any tax liability arising from a disposition or transfer of the assets of a bankrupt after the bankruptcy should be deemed to be a claim against the bankrupt arising at the date of the bankruptcy provable in bankruptcy. The trustee should not be personally liable for any such tax.

21. The final accounts of the trustee should be sent to all proven creditors before being approved by the court.

22. The trustee should be entitled to a redirection of mail by giving notice to Canada Post rather than by obtaining a court order with respect to all bankrupts except a consumer debtor.

23. A trustee of a consumer bankrupt should only be entitled to a redirection of mail with a court order.

24. Where a debtor tenders a certificate of discharge to a sheriff, any right of seizure or execution issued against the bankrupt or its property prior to the date of the bankruptcy should be released.

25. If a debtor stipulates in a proposal that it will pay a lump sum under a proposal there should be no further liability for failure to disclose a liability if the trustee gives a public notice by advertisement to the creditors of the payment of a final dividend at least 30 days prior to such a payment.

26. An assignment of wages should be void with respect to all wages earned after the date of bankruptcy.

27. The trustee should be given the right to deliver a notice by personal service, or otherwise with leave of the court, requiring a secured creditor to file a proof of security interest. Such proof should include details of the date when the security interest was given or taken, the amount owing to the secured creditor, the value at which the secured creditor assessed the property subject to the security interest, a copy of any security agreement and particulars of any filing or registration thereof, and whether or not the secured creditor is related to the debtor and if so how.

28. If a secured creditor does not file a proof of security with the trustee within 30 days after receiving such a notice, the trustee should have the right to sell or dispose of the property free and clear of any security interest therein held by such secured creditor. If the secured creditor subsequently files with the trustee proof of a valid security interest before the trustee has distributed the proceeds of sale among the creditors, the secured creditor should be entitled to the net proceeds realized from the sale of the property subject to the security interest after deducting all the trustee's expenses, including its remuneration relating to such realization. Otherwise the secured creditor should have no claim to the proceeds of realization.

29. A trustee should be given the right to disallow by notice any right of priority, any security interest and any bill of costs or expenses. The creditor should have the right to appeal from such disallowance within 30 days.

30. Where the trustee has disallowed a claim and the creditor has appealed from such disallowance, Section 106 of the *Bankruptcy Act* should be amended to give the court the power to determine the amount to be reserved on account of such claim for the purposes of an interim dividend. The amount of the reserve should not be arbitrarily restricted to the amount that would be payable upon the claim if the claim were allowed in full.

31. Section 106 of the *Bankruptcy Act* should be amended to give the trustee the right to disallow by notice any security interest, any claim to preferential treatment under Section 107 of the *Bankruptcy Act* and any bill of costs for expenses. The creditor should have the right to appeal from such disallowance within 30 days. If a secured creditor fails to appeal within 30 days, the trustee should have the right to sell or dispose of the property free and clear of any security therein held by such secured creditor. If the secured creditor subsequently successfully appeals from the disallowance before the trustee has distributed the proceeds of realization among the creditors, the secured creditor should be entitled to the net proceeds realized from the sale of the property subject to its security after deducting all the trustee's expenses, including its remuneration relating to the realization of the property. Otherwise the secured creditor should have no claim to the proceeds of realization.

32. A third party suffering a loss should have the right to claim the proceeds of liability insurance payable by the insurer of the bankrupt. This would not apply to the proceeds of reinsurance unless the terms of the policy of reinsurance otherwise provide.

33. The court should be entitled to require an applicant for the appointment of an interim receiver to give security for any damages suffered by the debtor as a result of the appointment or acts of the interim receiver.

34. The Act should set out specific provisions for the discharge of obligations and repayment of debts of an interim receiver.

35. The Act should provide for the termination of the appointment of an interim receiver when a proposal has been made and approved by the court, when a receiving order has been made or when the term of the appointment fixed by the court expires.

36. The trustee of a bankrupt estate or acting in a proposal should be given the right to redeem property subject to the claim of a secured creditor by paying the amount owing to the secured creditor or the value of its security stipulated by the secured creditor in a proof of security interest.

37. The trustee of a bankrupt estate or acting in a proposal should be given the right to pay the arrears owing to a secured creditor in order to have the loan put back into good standing and any enforcement proceedings resulting from such non-payment stayed.

38. The Official Receiver or its nominee should act as chairman of all meetings of creditors.

39. A quorum for a meeting of creditors should consist of one creditor who is entitled to vote as an unsecured creditor.

40. In the calculation of votes at a meeting of creditors there should be one vote for each dollar of claim.

41. A corporation should be entitled to vote at a meeting of creditors without filing a proxy.

42. In addition to those persons whose right to vote at a meeting of creditors is restricted by the present *Bankruptcy Act*, additional persons such as the solicitor or auditor of a debtor should be excluded

from voting, on a motion to substitute the trustee or to appoint an inspector.

43. If a petition for a bankruptcy receiving order has been filed prior to the filing of a proposal and the proposal is either not accepted by the creditors or not approved by the court, the trustee named in the petition should be appointed trustee of the bankrupt estate.

44. If the debtor has either filed an assignment or is deemed to have filed an assignment, the creditors should be given the right to substitute one trustee for another by an ordinary resolution. If the trustee was appointed as a result of being named in the petition for a bankruptcy receiving order, the present provisions of the *Bankruptcy Act* requiring a special resolution to substitute one trustee for another should be retained.

45. Cumulative voting should be allowed on the appointment of inspectors.

46. There should be rules set out in the Act governing the conduct of an inspector with a conflict of interest. Such rules should include a requirement that any inspector with a conflict of interest declare this interest to the board of inspectors and the trustee and withdraw from any meeting of the board of inspectors when such matter is discussed. In addition, the inspector and any creditor with a conflict of interest should not be entitled to have access to any documents connected with such matter.

47. A creditor or an inspector should have the right to participate in the meeting by telephone with the consent of all other persons participating in the meeting.

48. Creditors or inspectors should be entitled to vote by written resolution.

49. The trustee should be required to send a report summarizing the administration of the bankrupt estate including any relevant financial information to each proven creditor once a year unless the court otherwise orders.

50. The dismissal of an employee as a result of the person's bankruptcy order or proposal should be prohibited.

51. A public utility should be prohibited from discriminating against a bankrupt or debtor who has filed a proposal.

52. A trustee or receiver who carries on the business of the debtor should be required to honour any obligations of the debtor to its employees arising during the period that the business is carried out but should not be responsible for obligations incurred prior to its appointment, such as vacation pay accrued prior to the appointment of the trustee or receiver.

53. The failure of a responsible person or a former responsible person to perform duties imposed by the *Bankruptcy Act* should be an offence.

54. Except with leave of the court, no action should be permitted to be brought against an interim receiver.

55. A receiving order should not be stayed by an appeal unless a stay is ordered by the judge or court appealed to or from.

56. A limitation period should not run when proceedings are stayed.

57. There should be prior publication for at least 60 days of every regulation proposed under the *Bankruptcy Act*.

58. A trustee of a bankrupt estate should not be entitled to waive the bankrupt's solicitor-client privilege with respect to communications between the bankrupt and his or her solicitor. It is our opinion that the right of an individual to confidential legal communications should be maintained. This right to maintain solicitor-client privilege should extend to officers and directors of bankrupt companies. A solicitor should be required to disclose to the trustee of the bankrupt estate details of his or her dealings with the property of the bankrupt such as payments to and from a trust account.

59. The provisions of the *Bankruptcy Act* and the Bankruptcy Rules requiring the use of registered mail should be abolished.

Bankruptcy Offences

1. The committee recommends that the maximum fines and terms of imprisonment set out in Part VIII of the *Bankruptcy*

Act, which deals with bankruptcy offences, should be increased. For example, the maximum fine should be at least $50,000 instead of $1,000 in sections 171, 172 and 173. In Section 174 the maximum fine for removal of the bankrupt's property without notice should be increased from $5,000 to $50,000.

2. The committee recommends that the public authorities should take a more active role in the investigation of the affairs of bankrupts and there should be a more vigorous effort to prosecute offences under either the *Bankruptcy Act* or the *Criminal Code*. It is essential for the protection of our credit system that persons who take advantage of bankruptcy laws to obtain releases of their obligations should be punished if they attempt to secrete or improperly dispose of assets that should be available for distribution among their creditors.

CONCLUSION

In this report we have outlined the most important areas where the *Bankruptcy Act* should be amended. It is very obvious that changes in the *Bankruptcy Act* are required in order to improve the administration of insolvencies in Canada. We sincerely trust that these legislative changes will be enacted in the near future and the disappointing history of previous abortive attempts to introduce new insolvency legislation will not be repeated.

There are certain areas where further study is required before legislative changes are proposed. In technical areas such as insolvent insurance companies there should be close consultation with representatives of the particular industry in order to develop appropriate insolvency legislation.

This report represents the collective wisdom of persons dealing in insolvency matters from coast to coast in Canada. We have attempted to suggest amendments that would make the *Bankruptcy Act* more effective in dealing with modern problems without losing the benefit of established jurisprudence. Our recommendations are designed to effect a proper balance among the rights of creditors, debtors and the public interest.

The committee has been assisted by our advisors, Marie-Paule Scott and Jean Sirois. We express to them our appreciation for their efforts.

Respectfully submitted,

January 3, 1986

GARY F. COLTER
Chairman